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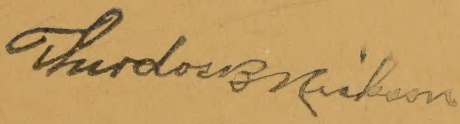

Also by MAHLON D. MILLER. . . . BANK SALES MANAGEMENT. . . . Discusses from experience practical methods of increasing a bank's business in its various departments. Specific in its suggestion for securing more business from present customers and attracting additional ones.

BANK LOANS ON STATEMENT AND CHARACTER

By

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DEDICATED TO

ONE WHOSE KINDLY ADVICE AND GENEROUS ENCOURAGEMENT HAVE BEEN A SOURCE OF INSPIRATION WHICH NO TRIBUTE OF ACKNOWLEDGMENT COULD EVER REPAY

MY UNCLE

FRANK P. BLAIR

PREFACE

With the growth of business enterprises and their increasing financial requirements there has come into wide use in the last two decades or so the practice of negotiating loans with banks upon the borrowers' financial statement and character. The present work is concerned with such unsecured commercial loans, and in undertaking it, the author has striven, in the light of a wide experience in examining into the condition of borrowers, to make a thoroughgoing analysis of the controlling factors involved in making commercial loans and to set forth his conclusions as to what policies have proved successful in safeguarding and encouraging the use of this class of accommodation.

The specific aims of the volume are two-fold in the main: First, to assist the commercial banker in extending such accommodation upon a sound and safe basis; and second, to aid the borrower to prepare his loan application so that he may get all the consideration he is entitled to. As corollary to these two objects the author has had also in mind the possible effect of the volume in helping to promote sounder credit conditions in general and happier relations between lender and borrower.

The volume is organized to cover comprehensively the various steps involved in the internal and external investigation of the borrower's credit standing made by the lending bank. It necessarily discusses at much length the proper presentation to the banker of the borrower's balance sheet and profit and loss statement and the methods used by the former in analyzing the statements. In this connection, in order to enhance the practical value of the discussion, the illustrations cited are, as far as possible, cases in which financial statements that

have actually been submitted by borrowers to lending banks are presented and analyzed, together with such conclusions in most instances as the bank itself had reached. The figures in those statements have been altered somewhat to conceal the identity of the concerns, but care has been taken to preserve the exact financial ratios of the original statements.

It gives the author great pleasure to acknowledge the assistance and helpful suggestions received from a number of persons. He wishes particularly to express his appreciation, for their co-operation and helpfulness, to Mr. David Sweet, Assistant Cashier and Manager of the Credit Department of the National Bank of The Republic, Chicago; to Mr. Henry Getz, Manager of the Credit Department, A. G. Becker and Company, Chicago; to Mr. Eugene Delaney, Manager of the Credit Department, the Federal Reserve Bank, Chicago; to Mr. Edward F. Reiter, Manager of the Credit Department, the Continental and Commercial National Bank of Chicago; to Mr. M. A. Pettengill, of Kohler, Pettengill and Company, Chicago; to Mr. Hugh N. Smith, C.P.A.; to Mr. G. A. Norton, C.P.A.; to Mr. G. B. Waterstraat, Coats and Burchard Company, Appraisers, Chicago; to Mr. John G. Thornton, Superintendent of the Bradstreet Company, Chicago; to the Economist, Chicago; to the Robert Morris Associates; and to the National Credit Office.

MAHLON D. MILLER.

Chicago, Illinois,
November 10, 1927.

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BANK LOANS ON STATEMENT AND CHARACTER

CHAPTER I

ESSENTIALS OF BANK CREDIT

Conditions a Generation Ago and Today.—Commercial loans are today a dynamic factor in our industrial progress. Through successive business cycles, through periods of inflation and deflation, the system of unsecured borrowing on character and statement has developed to meet the requirements of business. To clearly understand the workings of commercial credit today, it is necessary to trace the evolution of commercial loan requirements, and to visualize the relationship between the banker and his customers as gradually changing with the depositor's methods of conducting business, and his consequent banking needs.

When about thirty years ago the practice of requiring statements from borrowers was introduced, commercial loans were made upon the general reputation of the borrower, and the quality and the extent of the information upon which banks then granted credit was such as bankers would today consider beneath notice. Relationships between the banker and his clients were then more personal. Business undertakings were smaller in the last generation, and impressions regarding the borrower's character, his capacity, and the extent of his capital, were more easily and accurately formed from the local gossip which filtered in from the community. As a leading citizen in close touch with the important businesses of his territory, the banker combined to a larger extent, social as well as business leadership. This enabled him to know his borrowers largely from personal contact and life-long experience.

Today, bankers in financial centers have found it necessary to go about determining the applicant's fitness for credit more

comprehensively. Business has expanded and outgrown the local character it once had, giving rise to wholesale credit extensions, which make it imperative that bankers and business men possess a wide background of credit knowledge and experience to enable them to analyze correctly their financial problems. Where before banks loaned largely to individuals and small concerns, today they extend accommodations largely to corporations and gigantic concerns having similar characteristics in operation and management, making possible the application of established credit standards. The personal element is eliminated in complex organizations which deal as a corporate entity with the public and the banks. Thus the banker finds that much of the intimate touch is lost, and that consequently it is more difficult than formerly to estimate the personal side of the risk, which has made it necessary to base opinions largely upon a scientific investigation of the history of the management, and upon an intensive analysis of the financial records of the borrowing individual, firm or corporation.

Practice of Furnishing Statements.—From the time when affairs in this country were in their financial infancy—when the needs of merchants were comparatively small, at a period when the method of loaning funds secured by a note endorsed by two or more accommodation endorsers was in wide use—there was a gradual evolution in the character of the borrower's obligation. With the passing of the intimate business contacts and limited operations which had curtailed the use of financial statements, up until the period of the rapid industrial development which followed the Civil War reorganization, bankers began to encourage their borrowers to furnish statements as a base for credit extension.

From a loaning standpoint the importance of this new practice cannot be over-emphasized. Where before banks had loaned only upon endorsement, or had extended credit on two- and three-name paper, or on trade acceptances and accommo-

dation paper, they now loaned upon the individual responsibility of the borrowing individual, firm or corporation. From out of this development in business finance there came the widespread practice, now in general use, of banks requiring from their customers financial statements of their affairs. It is customary now to accept the straight note of the borrower without requiring endorsers, with maturities of from 30, 60 to 90 days, consistent with the prevailing credit terms, allowing the borrower to take advantage of the discounts, purchase materials or care for direct labor cost.

Under this new era of what might be called single-name paper, losses have become fewer than under former methods, and bankers are generally agreed that the evolution into the existing method, while it has its imperfections, is along sound economic lines. Where, as before, there were several individuals on a note, it was difficult for the banks to place definitely the responsibility. There was a tendency toward the hiding of assets by endorsers to avoid payment of liabilities from which they received no benefit. Now, with the practice of loaning on the financial statement unsecured, basing the responsibility for payment upon the character and general credit standing of the individual, firm or corporation, banks experience less difficulty in collecting their notes. It is with this type of borrowing that the discussion to follow will be concerned, so that the reader may view, in concise form, many of the practices now in general use governing this method of commercial financing.

The Commercial Banker's Function.—Out of the historical development of American business methods there have emerged certain well-defined principles governing the loan operations of a commercial bank. These are basic principles of universal scope. They mark out the commercial banker's legitimate operations, and may be applied to every banking business.

The function of commercial banking, as distinguished from investment banking, is to facilitate or speed up the use of capi-

tal by making future credits available for immediate use. It is not the proper aim of a bank to supply its customers with capital, nor to go into partnership with them. It does not supply them with funds for indefinite periods. Indeed, in making commercial loans, banks are forced to require not only that the loans be ultimately good, but that they be of comparatively short maturity, so that reserve funds may be kept constantly in liquid condition—instantly available for any contingent demand of business and customer.

Influence of Federal Reserve Standards.—To encourage this liquidity of commercial loans definite credit standards have been set up by the Federal Reserve Banks. While there are many banks which are not members of the Federal Reserve System and may not, therefore, come directly under its influence, yet, indirectly, through correspondent banks, these non-members feel the effects of reserve bank standards through contact with members who avail themselves of the rediscount privilege. Each member bank wants to have the largest possible portion of its paper eligible for rediscount. This, in turn, determines, to a certain extent, the character of the bank's loans to customers, for they have found it more profitable to make their paper conform to federal reserve requirements, because such paper commands the lowest rates. Even taking into consideration those banks which are outside the Federal Reserve System, and making allowance for the possible defects which exist, investigations have shown that bankers are generally of the belief that the federal reserve standards have become more or less the ideal to which a certain part of the loans made to bank customers should conform, and to which the remainder might wisely tend because of their consequent liquidity.

In order to preserve the fluidity of their reserves the reserve banks have found it necessary to require that the paper rediscounted with them shall be self-liquidating. This means that loans must be based upon commodities which are being

produced or are moving to market, and the sale of which will provide funds for discharging the indebtedness against them. When the requirement was made that paper arising out of industrial or mercantile transactions must have a maturity not in excess of 90 days at the time of rediscount, it tended to shorten loan maturities with most commercial banks. And while livestock and agricultural paper is allowed a discount privilege now extended to cover maturities running up to 9 months, with a view to assisting the farmer and stock raiser whose financial returns are slower, the whole structure of commercial loans leans toward short maturities.

This need for short maturities is important, since the bulk of the deposits of most commercial banks is payable on demand, making it necessary to keep their funds liquid to meet withdrawals. Hence, when the commercial banker discounts the notes of his customer for a short period of from 30 to 90 days, he does not wish merely to be assured that these notes will be paid ultimately, but that they will be paid when they come due. Such a policy is also consistent with the short terms of payment in meeting obligations now prevalent in most lines of business.

Abuse of Commercial Banker's Function.—In spite of these generally accepted requirements with respect to maturities, commercial banks have been called upon to go beyond the normal scope of their activities and to participate in long-term financing, making advances which tied up their funds for considerable periods, and to assist in permanent financing which comes more properly within the province of investment banking.

When loans are made to concerns and individuals for the purchase of real estate and for the financing of such capital improvements as the construction of buildings and the extensions of plant and equipment, the proper function of the commercial loan is abused. Yet, much financing of this kind has been

performed by the commercial banker because facilities of other kinds were lacking. At times, of course, emergencies have arisen under which loans for this purpose have been made by commercial banks to concerns where the financial statement and supplementary circumstances warranted it.

But in striving always toward liquidity, the banker has come to realize that to the extent that he ties up any considerable proportion of his funds in long-time, non-liquid investments, by just so much is his ability to fulfill his function as a commercial banker reduced. He has come to know that while money is plentiful and times are favorable, the mistake of going beyond the scope of temporary and into permanent financing is not realized, but that in troubled times, when the customer's needs are urgent, it becomes a serious disadvantage, which often brings with it commercial stagnation and failure. He then comes more clearly to recognize that appeals for funds for long-time capital improvements should, in most instances, be directed to the investment market where such facilities are available, and rightly limits himself to facilitating current production and distribution through the medium of unsecured commercial credit.

Forming the Background of Credit.—The necessity for unsecured commercial banking credit arises when merchants and manufacturers sell merchandise on open account, with credit terms running from 30 to 90 days or longer, and create additional financial burdens. In extending credit, business executives must necessarily carry the financial responsibility until the accounts are paid in full. They allow their buyers to order goods and pay for them after a period of time, often long enough to allow for a resale before payment falls due. Under these operating conditions, concerns must obviously be strong enough financially to carry their debtors, or borrow for the purpose of carrying them. Because many enterprises are relatively limited in resources—operating with

modest capital—it is but natural for them to call upon the commercial bank for assistance. Hence the need for commercial loans.

Another cause of the extensive demand for commercial loans is the practice of offering cash discounts for prompt payment of accounts. It follows that if a merchant is to pay cash, he must have cash in order to take advantage of these concessions. In consequence unsecured commercial bank loans are turned to as the medium through which to finance these operations.

In making unsecured loans experience has pointed to the necessity of loaning funds upon the individual responsibility of individuals, firms and corporations. And in determining the borrower's responsibility it is generally agreed by bankers that the three primary essentials to banking credit are: Character, Capacity, and Capital. Together they are known as the "Three C's" of banking credit. They are helpful to the banker in forming the background of credit. They are valuable as a starting point for the credit man, and form a logical basis for approaching credit problems; but they should be looked upon more as a starting point for a searching analysis of the facts, rather than as a formula of credit which may be applied automatically to credit problems which are to be solved. Thus they are important as essential elements to consider in judging a risk, but business operations have become so complex, and corporate organizations have become so large that it may be rightly said that were the banker to stop with but these three essentials to credit, he would be at fault. Thus in discussing the three C's in relation to commercial loans, they will serve merely as an introduction to the broader and more comprehensive analyses to follow.

Character of the Borrower.—No matter what the age of the borrower, character has always been the chief requisite. The medium of exchange between the borrower and lender,

as well as the nature of the obligation, has changed, but through every transition in commerce the character requirement has been a primary consideration.

The character of the borrower as it pertains to banking credit covers a wide range of human factors which taken together form the basis for judgment. It is essential to view the risk from many angles, and specific reference to a few of the more common points to be considered should prove enlightening.

The Man Himself.—What is known of his personality? Is he temperate in his habits? Are his associations consistent with what is known of his general character?

Business and Social Standing.—Has the prospective borrower any old debts unpaid which reflect upon his honor in business, socially, or otherwise? Has experience ever shown that he shirked responsibility and allowed his associates to carry his financial burdens for him in an emergency?

Reputation for Honesty.—Very important is the man's reputation for honesty. Among other significant questions which might be asked are: What is the past record of the borrower and his associates for honest dealing? Is he in good repute with his fellow tradesmen? All the foregoing qualities are important, but a man may have them and still be lacking in the other important essentials.

Capacity of the Borrower.—The capacity of the borrower covers a wide range of things, and includes business ability, judgment, and other essentials needed for successful business.

Capability of Management.—Among other things, the age, physical condition, and the general equipment of the individual, partner, or of the officers and employes of a corporation, personally, to carry forward successfully the undertaking, are important. Are they versatile and capable of adjust-

ing themselves quickly to changing conditions, and cool in judgment in the face of financial upheaval? Have they ever passed through periods of operation when business ability was at a premium? Take the case of two packing companies, for example. Suppose they were both about the same size, buying from much the same sources, and selling in competitive markets. Let it be supposed that one of these companies had operated successfully through periods of financial depression, and that the management had shown marked ability to progress even in the face of great financial abnormality, while the other company had never had this experience. It is apparent that the experienced management would be the better risk.

Past Business Experience.—What has been the past business experience? Has the management been long trained in the particular business, advanced through merit, or through influence, or the mere possession of capital? Have the individuals, personally, and the business been successful in the past? If so, for what length of time?

Capacity as Related to the Business.—Capacity as pertaining to the individual is important, but it is also significant as related to the business risk, as distinguished from the man. For example, an individual may have much capacity, but may have an inadequate plant or physical equipment to deal with, which makes successful operation impossible.

Thus capacity as associated with the business risk brings up some questions related to the general and specific condition of the business. Is the business diversified in its products, or is it dependent upon one type of goods? What is the outlook for the future relative to business conditions? The failure of an individual to succeed in a venture may be almost wholly due to business conditions. Competitive conditions and depression may be such that an established house with some accumulation of surplus from the prosperous years, may exist for some time,

while a younger, less established enterprise might not be able to survive. Is the company's trade well diversified geographically throughout the country, so as to eliminate the possibility of failure through a depression in any particular section? Probability of success, therefore, depends not alone upon capacity, character or capital, but upon the condition of the industry. What about the company's legal status? Have there been any past lawsuits which might prevent or handicap future progress? These are a few of the considerations which might affect the capacity of the management to operate, and which indirectly bear upon the question of capacity and the borrower.

Capital of the Borrower.—An individual, firm or corporation may have character, and considerable capacity, but without the necessary capital intelligently distributed throughout the financial structure, and sufficient to finance the business and provide for its expansion, banking credit may not be justified.

Liquidity.—By this is meant the readiness with which the assets of the corporation or company may be converted into cash in case of an emergency. Will the management have enough coming in, in receivables or other assets at the maturity of the loan, to pay it, or will they be steady borrowers and seldom be able annually to pay their loans? Is the capital ample enough to keep pace with anticipated expansion?

Character.—The nature of the capital is important. The division of capital into the various types of assets and its relation to other financing may be more important than the amount of capital itself. Is the capital borrowed, inherited, temporary in its participation in the business, or permanent? Have the officials of the company loaned funds to the company which they are liable to call in for other enterprises? Has the company much goodwill in case they desire to sell further stock for additional working capital? In case of the death of any of the officers, is there any insurance to take care of the loss of

their services and the possible withdrawal of capital by the heirs?

Disbursement.—Are the earnings "plowed back" into the company, or is the company being "bled" to death by heavy dividend payments? Is the surplus put into securities such as Liberty bonds, or is it spread out over different holdings of the company which may or may not strengthen the position or the undertaking relative to its capital standing?

Fixed Investment.—Whether or not the capital is in fixed assets, or quick or self-liquidating assets, is also important. Is the company top-heavy with real estate, machinery, or other fixed assets? Is the capital large enough to keep all the units of the business in full operation? Also the following should be ascertained:

(a) What provisions, if any, have been made to wipe out bad accounts?
(b) Has a sinking fund been arranged to care for depreciation of physical properties?
(c) Has a sinking fund been set aside for the retirement of bonded indebtedness?
(d) Is there sufficient working capital to finance the sales growth of the company?

Whether merchant, manufacturer, or banker, if an effort is made to establish the truth by a searching investigation regarding a borrower's financial condition, based upon questions like the foregoing, there need be little fear that the decision will be an unfair one.

Relative Importance of the Three "C's" During Periods of Inflation and Deflation.—The relative importance of the three C's of banking credit, *Character, Capacity,* and *Capital,* is emphasized during periods of financial abnormality. Under the stress of financial upheaval they become more essential to suc-

cessful operation. It is interesting to note from an analysis of the following tables, the relative importance of the three C's as pertaining to the causes of business failures, and to observe them in connection with the number of failures which occurred during the years 1915 to 1926, inclusive.

CAUSES OF FAILURES FOR 1921 [1]

	Percentage
Lack of experience and capacity	38
Lack of capital	29
Extravagance, neglect, speculation, fraud	7
All other causes	26
Total	100

NUMBER OF FAILURES, 1915-1926 [2]

Year	Number	Liabilities
1915	22,156	$302,286,148
1916	16,993	196,212,256
1917	13,855	182,441,371
1918	9,982	163,019,979
1919	6,451	113,291,237
1920	8,881	295,121,805
1921	19,652	627,401,883
1922	23,676	623,896,251
1923	18,718	539,386,806
1924	20,615	543,225,449
1925	21,214	443,744,227
1926	21,773	409,232,278

When the year 1921 is taken, it shows that during that year 38% of the failures were attributed to lack of capacity; the executives heading these failed enterprises lacked the necessary business experience and ability to weather the storm which struck them in 1920 and 1921. During the year 1921, also, the table shows that 29% of the business failures were due to lack of capital.

First, there was a period of inflation and rising prices, when all types of business management were able to make a good showing. It will be noted that from 1919 until 1923 there was a steady increase in the number of business failures. The number decreased in 1923, but from then it continued to increase

[1] Bradstreet's for 1921.
[2] R. G. Dun & Co., The Record of Insolvencies.

and in 1926 was 21,773. During the period of abnormal and over-expanded business, business capacity, or ability and experience, were at a premium, and those who were not competent failed. For two years in succession the total liabilities of the failed concerns were well over $600,000,000 annually, which is in marked contrast with an average total of but $190,000,000 during the preceding five years of war and post-war stimulus. It is the contrast between the era when money-making was simply a matter of holding merchandise until it increased in value, and then selling it, to a period when loss-taking was inevitable. Caught in the drastic turn of the business tide, when current prices and sales dropped, many enterprises found that they were unable to finance the depression which struck them, and failed for want of sufficient capital to replace their heavy losses.

In 1926, with personal responsibility for all failures aggregating 80.4%, and non-personal causes given as 19.6%, it was found that the causes were as follows:[3]

	Per Cent
Lack of experience and capacity	39
Lack of capital	32.7
Fraud	3.8
Other cases	24.5
Total	100%

It will be noted by comparing the above figures with those of 1921 that lack of experience and capacity is still the largest cause of business failure. An analysis showed that inexperience alone, with 5.1% of all failure charged to it, was at the highest point since 1921. It will be observed that the personal element in connection with success or failure is an important factor.

Presenting the Three "C's" Correctly.—To the borrower it is a matter of vital importance correctly to present to the banker his qualifications as to character, capacity, and capital.

[3] Bradstreet's for 1926.

Many otherwise successful business executives fail to inspire banking confidence because they do not appreciate the importance of introducing properly in the application for a loan their qualifications as revealed in the three C's. To establish the proper credit background as a basis for securing the cooperation of the banker in making his complete analysis, the borrower should present an audited report and a statement certified to by a certified public accountant. In preparing such a report, the points given below, among others, should be considered. The statement should begin with the usual introduction, and then go into detail as follows:

1. It should take up the capital stock, both preferred and common, and go into detail concerning its history, ownership, and legal aspects.

2. It should give the dividend policy; it should show that surplus, if any, which was earned, and that which was originally contributed by the common shareholders. A further perusal should show a detailed analysis of surplus account for the year.

3. A list of the insurance carried should be itemized by companies, amounts and expiration dates. The report should show that all policies carry an 80% co-insurance clause. The valuations given for insurance purposes should be based upon the report of an accredited, certified appraisal company.

4. Next should come the information regarding the company's banking connections, with a statement as to whether the checks may be signed by the president, secretary, treasurer, or manager, and whether they are required to be countersigned by certain officers. Appended to this should be the report of the audit company showing that all vouchers have been checked and properly approved by its officers.

5. A series of inventory tables, giving merchandise valuations, the amount of real estate holdings and other assets, should be shown, based on a certified appraisal.

6. There should be detailed tables, too, of income and expense, returned goods, bills receivable, and bills payable.

7. The annual and average profits should be shown, and there should be a "liquidation statement" which aims to show what could be realized should the company wish to go out of business.

8. A list of creditors should then follow, with the amounts, the dates due, and the names of the officers of the corporations. The company may show that it does not endorse for outsiders nor allow its officers to do so.

9. Then the question should be taken up as to whether or not there are any contingent obligations, pending suits or judgments, debts past due, and whether all merchandise bills have been discounted within 10 days.

10. The individual record of the company's officers will be included in the document. The main headings are: age, salary, business record, married or single, interest in the company, clubs, insurance, duties, habits, outside interests, liabilities, health and education.

When the loan official proffers his suggestions as outlined above regarding the correct presentation of a loaning application, sometimes there is assent, and sometimes a restive discontent shown by the depositor. But the wise borrower is a co-operator; he is willing to furnish all the banker requires to establish his character, prove his capacity and reveal his assets in justice to himself and the bank. The hasty, high-pressure borrower, who relies on his personality and sales efforts to sell the banker, rather than the presentation of the proper data, often fails to receive accommodations through misguided procedure. But the seasoned borrower, the man of affairs, ever ready to place himself in the position of another to gain his rightful ends, wins the banker's hearty endorsement, and receives the limit of legitimate accommodations.

CHAPTER II

IMPORTANCE OF FINANCIAL STATEMENTS

Statement Essential to Obtaining a Loan.—Building up a great financial structure upon future promises to pay has made necessary complete financial statements from commercial borrowers. Whether they be merchants or manufacturers, it is a generally accepted practice for borrowers to furnish satisfactory evidence of their possessing the capital, as well as the necessary capacity, and force of character, to carry out their end of the transaction. For the banker the financial statement is of primary importance, because when properly made out, it proves an accurate index to the extent the borrower possesses the necessary character, capacity and capital. That is, the financial statement or balance sheet is looked upon as an important source of information as to the borrower's condition.

A merchant's most valuable possession, aside from his material assets, is a good reputation as a credit risk, and under present methods of conducting business, the best way for him to prove his title to credit is to submit a statement of his financial condition. Asking him to do so casts no reflection upon his character, honesty or business ability. It is simply an effort on the part of banks to obtain information whereby dealings can be intelligently conducted. The giver of credit is a contributor of capital and becomes, in a certain sense, a partner of the debtor, and as such has a right to full knowledge of his financial condition at all times.

Importance of the Statement to the Banker.—Because the statement plays so important a part in the discussion to follow, and because there are still many business executives with limited

financial experience who feel diffident about rendering periodic statements, it is proposed to show their importance both to the borrower and to the banker.

Some borrowers take it as a personal offense if a bank requests a statement when they seek a loan. But it is hard to conceive why this should be so. If it is true that most merchants would not grant credit to a prospective customer without first informing themselves as fully and completely as possible as to his general credit standing or worth, why should a merchant or individual borrower expect a bank to become a temporary investor in his business enterprises without being fully informed as to his actual condition as the basis for investment?

The man who applies for credit and who refuses to disclose to his banker the condition of his affairs, but refers instead to mercantile agency ratings or to his supposed business standing in the community, is not entitled to much consideration. The practice of receiving statements from customers has become today so universal that it is absurd for anyone to expect credit unless he furnishes his banker sufficient information about his affairs to enable him to do his business on an intelligent basis.

To get the true perspective the borrower should look upon his banker more as a partner than as a father confessor, more as a doctor than as an inspector. To give financial aid, the banker, like the doctor, must have all the financial symptoms—he must first possess the facts before rendering his judgment upon them.

The financial history outlined in the statement is of as much importance to the banker as the physical examination is to the examining physician. Without an investigation what good could come from the physician's prescriptions? How could the patient's symptoms be ascertained, moreover, without taking the doctor into his confidence?

When the loaning banker is called on, he examines the borrower financially with the same thoroughness with which a

doctor examines a patient physically. His conclusions are necessarily substantiated by asking the patient, the financial borrower, pertinent questions relative to the condition revealed by the facts presented. The measure of the banker's helpfulness will depend upon the condition of the firm or individual under examination, and upon the co-operation he receives when making his inquiries and offering his financial prescriptions.

Without reposing the same confidence in the banker that is reposed in the family doctor, the borrower will never realize the maximum of assistance from his bank to which he is rightly entitled. It is imperative that the borrower at all times willingly and frankly inform the banker as completely as possible regarding his financial position. This can only be accomplished by sending in periodic statements which will disclose in complete detail the true condition of his affairs.

Importance of the Statement to the Borrower.—Looked at from the borrower's point of view, there is also much to be said for the custom of rendering financial statements on request. They cement the business alliance between him and the banker, and establish a basis for continued and mutually profitable dealings. Among the more important benefits that accrue to the borrower from rendering periodic statements are the following:

Confidence Built Up.—First of all, the practice of keeping the banker informed through regularly audited financial statements promotes lasting confidence and goodwill. The borrower who shows a willingness to take the initiative in establishing his own financial position as a risk, by his frankness bolsters up the banker's confidence. A readiness to disclose information is a good indication that there is nothing to conceal. Placing the history of the borrower's financial condition before the banker clarifies the relationship and brings to the surface the true situation, marks out the obstacles to progress which con-

front the depositor and shows to the banker in what respects it is possible for him to lend assistance.

Co-operation Promoted.—Often when the borrower informs the banker in his statements of movements proposed by the management, he secures a closer co-operation. By keeping the bank informed of his progress the borrower often, in return, gains much valuable information.

As a case in point an interview with a large coffee importer is cited. During the course of a visit with his banker the merchant remarked that he confided in, and leaned heavily on the foreign department of his bank for advice in buying exchange. In addition to his financial statement, it had been customary for him to give the foreign department his position regarding exchange, and to outline his needs. "Why," he said, "I would be lost without the advice of my banker on these matters, and an error in foreign exchange operations at a critical time would cost me thousands of dollars!"

To realize the maximum of co-operation the borrower must give to his banker in return a complete statement of his requirements, so that the bank may know what is needed, and fulfill these needs as completely as the facilities of the institution will permit.

Sound Advice Insured at Minimum Cost.—Nowhere can the borrower receive sounder advice than from his banker. The bank official always has the interests of his clients at heart, and is ready at all times to talk over their financial problems with them. Because of the close relationship existing between them, the advice and counsel given is apt to be more pertinent than that which could ordinarily be obtained elsewhere, and the depositor will get, in return for his candor and open-mindedness, much helpful advice at a minimum of expense. Without rendering a financial statement it is impossible for the customer to outline quickly his position to the banker and therefore,

whether a loan is contemplated or not, presenting a statement when asking for financial advice is of the greatest importance; it is, in fact, the necessary first step toward getting the most out of the banker's reactions to the customer's financial problems.

Conservative Progress Encouraged.—Frequently when bankers are consulted by the careful business executive about some proposed expansion in the business, he gets some valuable advice that prevents loss and insures a more stable and conservative progress.

During a period of inflation a certain candy manufacturer contemplated making additions of plant equipment to enlarge his capacity. In consulting with his banker he was advised to hold off for a year pending readjustment. The manufacturer took the banker's advice and thereby saved thousands of dollars that would have gone into the proposed new plant and been tied up indefinitely in the form of fixed assets, as the result of the slump that came along and curtailed the production needs of the business. As it was, the enterprise went steadily forward on the old basis, and when business improved, the management was able to finance its expansion program much more economically and at a more strategic time, with an abundance of working capital assets to take care of all current financing as well.

Financial Expansion Helped.—Because of their training and experience bankers are well versed in financial matters and the borrower, by going over his affairs with his banker, is able to get the correct perspective on his financial problems. Thus a frank discussion of his plans is the only right basis for establishing close relations with his bank. More than one borrower has lost his financial support because he failed to realize the importance of keeping his "silent partner," the bank, informed as to his movements. The bank officials consulted concerning proposed financing sometimes seem hard to convince,

but to the thoughtful borrower with the correct amount of confidence, it only tempers his judgment, rounds out his plans, and eliminates obstacles which in some instances he might not have encountered until too late to provide against.

Not long ago the head of a large supply company in consulting with his banker found that an analysis of his statement showed a serious shortage of working capital. Further investigation brought out the need for selling further stock. As the concern was not listed on the exchange, it was necessary to work out some plan for merchandising the capital stock necessary to be issued without incurring a prohibitive sales cost. The depositor by taking his bank into his confidence was able to secure advice concerning a stock participation plan, in which it was possible to interest the employes in purchasing company stock, thereby furnishing the additional funds required more reasonably than could otherwise have been procured. Had not the borrower showed his statement to the bank official and discussed his affairs with him, he would not have been able to get the co-operation and valuable advice he received which made for his enterprise an appreciable saving.

Financial Difficulties Surmounted.—When the borrower gets into financial difficulty, he turns to his bank to help him out. Often the statement will tell a dramatic story as to how the enterprise has fallen down, and what is needed to straighten out its affairs.

In some instances the banker recommends a financial reorganization as a possible solution. Again, a change in operating methods may be advised, or perhaps a better system of accounting procedure is suggested. Often only a slight adjustment will make the difference between success and failure; and through gaining the unbiased opinion of the banker by laying all before him, the customer often finds the solution to his financial problems.

The comprehensive credit structure built up on the basis of

accommodations loaned upon the individual responsibility of the individual, firm, or corporation, makes especially necessary more complete and accurate financial statements. Financial statements are in a sense the guiding map by which financial progress is to be oriented. They point out to the borrower the errors of the past, the advantages in the present, and the prospects for the future. They are, to the banker, the most important source of information as to the financial condition of the borrower.

CHAPTER III

INTERNAL INVESTIGATION OF PAST RELATIONS

Two Main Fields of Investigation.—Establishing credit requires an extensive knowledge of the borrower. In gathering credit information banks cover many sources, but in a general way their activities in this direction may be divided up into two main divisions, the internal investigation and the external investigation as follows:

A. Internal Investigation Inside the Bank
   1. Financial statements
   2. Past relationships with the bank outside the commercial department
   3. Past relationships with the bank inside the commercial department
   4. Written memorandums of interviews with the borrower in the bank, and at the plant or office
   5. Internal plant or office inspections

B. External Investigation Outside the Bank
   1. Bank references
   2. Trade references
   3. Plant appraisals outside the bank
   4. Mercantile and other agency investigations
   5. Clippings

First there will be taken up for discussion the investigation pertaining to the past relations inside the bank. In the chapter following, the external investigation outside the bank will be considered.

Establishing Borrower's Line of Credit.—The borrower's internal relationship with the bank begins when he signs for an account. From that time on he makes his own banking history, which is recorded in the bank's records and credit files. This record of past relations furnishes the bank with one of its chief sources of information used in connection with establishing an unsecured line of credit. The line of credit or loan arrangement established upon the decision to grant credit to the applicant is expressed in an agreement on the part of the bank to carry loans up to a certain maximum at any given time for the depositor. It is customary for a concern to complete arrangements in advance for banking accommodations sufficient to care for the season's needs, and the line of credit represents the bank's agreement to furnish such accommodations or a portion of them. Such a line of credit is subject to revision upon the analysis of the bank's experience with the account after receipt of the borrower's annual statement, and at any time during the interval that there is such a change in the affairs of the beneficiary as to warrant it. The internal investigation made by the bank to establish the basis for a line of credit covers completely the bank's contact with the depositor and goes into detail concerning the sources of information which are herewith set forth.

Financial Statement as Source of Information.—First there is the financial statement, which is one of the most important sources of information used in determining the financial standing of the subject. There is the balance sheet setting forth the assets and liabilities; and the profit and loss statement which covers the income and expenditures. A detailed analysis and suggestions relating to their proper presentation will follow later.

Past Relationship with the Bank Outside the Commercial Department.—One of the most fruitful sources of information

is that obtained from the applicant's contact with the departments of the bank outside the commercial department. The more numerous the relationships, the more complete the credit information will be, and the more valuable the business transacted, the more interested the bank will be in co-operating with the borrower. In making the internal investigation the subject's experience with the following departments outside the commercial department, among others, will be secured.

1. Savings Department.—A prospective borrower may carry a small three-figure account in the checking department, and be found to have a high five-figure balance in the savings department, and to have established there, through years of patronage and as the result of his consistent saving, a reputation for integrity and force of character. Such information is helpful in forming an opinion concerning the risk, and the size of the balance carried will be taken into consideration when the application for credit is examined. The mere fact that a man carries a good savings account would not in itself entitle him to credit, but the relationship and its satisfactory or unsatisfactory character is taken into consideration.

A concern might carry relatively small three-figure commercial balances, and yet carry a large reserve in the savings department. Thus the credit man must be informed of such a relationship when passing on the risk.

2. Bond Department.—The subject's experience with the bond department is often enlightening. Upon investigating the bank may find that the individual or concern has been buying securities on the partial payment plan for years, and has built up a substantial reserve. The consistency of character shown by the depositor in making regular payments will be weighed in when considering the loan application. When securities shown on a financial statement are claimed to have been purchased through the bank and are set up as assets in a concern's balance

sheet, the amount and character of the securities may be checked with the bond department.

3. Trust and Real Estate Department.—Valuable information may often be gleaned from the prospective borrower's contact with the trust and real estate departments. If statements are made that an agency, living trust, or some other fiduciary relationship has been established by the applicant with the trust department, the information regarding such contact is checked and taken into consideration when passing on the application. Relations with the real estate department should also be checked.

4. Safe Deposit Department.—It is not unusual to gain light on the risk from the experience of the safe deposit department with the prospective borrower. He may be known through the close observation of the vault manager to possess certain securities about which nothing was said, but which might have some bearing upon the credit situation. Generally, however, this department, owing to the privacy of the relationship, cannot be expected to yield much credit information, but is mentioned here only as one of the possible sources of internal investigation and one yielding interesting sidelights on the borrower's character.

When a banker finds upon investigation that an applicant for credit has grown up financially with the institution and his upright character has been more or less established there with the officers of the bank, there is a tendency to take a more liberal attitude in the matter of accommodations than would otherwise be the case.

Past Relationship with the Commercial Department.—The commercial department's records show the past relations of the depositor and how the account has been conducted. Among other things, the average balances maintained, the

record of previous loans and discounts, if any, the interest rates, renewals or extensions of loans, notes protested, the type of borrowing, are all scrutinized carefully by the loan officer and furnish much valuable information. Certain stipulations are made pertaining to these things when granting a line of credit, which it is important for the borrower to live up to.

Balances Maintained.—In looking up the depositor's account the average balance is analyzed. It is the daily average balance that is the important consideration, and not merely the total amount deposited. This is recorded each month on the back of the customer's record card. But in taking into consideration the matter of balances the bank has to go farther. It is the net workable average balance with which the bank has to operate. Allowance must be made for the reserve to take care of withdrawals, and other reserves; the float on outstanding checks must be figured; the number of items handled each month and the overhead must all be taken into the analysis when determining the profitableness of the account to the bank.

The usual understanding between the customer and the bank is that an average balance approximating 20% of the line of credit will be maintained. However, this does not mean that the borrower cannot draw on his account below that amount. The bank only asks that he restore his balance when he is in possession of funds to a point high enough to carry an average for the period of the life of the credit line equal to 20%. Frequently the bank will lend five times the amount of the average balance which has been maintained for the 6 months prior to the time of granting the loan, within the limits, of course, of the maximum line of credit.

The importance of carrying adequate balances from a credit angle is not realized by depositors to the extent it should be. While from a technical standpoint the bank balance is nothing more than the excess of the merchant's daily turnover after

having paid the bills, yet it is his cash reserve for emergencies, and as such, comes in for the bank's careful scrutiny, not only as a safety factor, but also because deposits are necessary to a bank's progress.

The change in financial standards should be taken into consideration. The standards are not the same today as they were 5 or 10 years ago. The dollar, worth a hundred cents before the inflation period, is today only worth about 60 cents, depending upon the commodity. Yet, with changed conditions, with the altered buying power of the dollar, there are individuals and corporations that do not realize that it is necessary to carry more in the bank to pay their bills, and at the same time make their deposits interesting to the bank, which, because of the character of its business, aims to extend accommodations to those who are in a position to keep remunerative balances and live up to the balance agreements consistent with the line of credit.

The Record of Previous Loans and Discounts.—The information concerning the amount and character of borrowings in the past as shown by the records of previous loans and discounts is essential. On the back of the customer's record card there is space for recording the maximum loan opposite the monthly record of average balances. This gives the banker a summary by months of maximum loans, and the monthly average balance standing of the borrower. If the loan is secured by collateral, the record card shows this also. The stipulations made the borrower are shown in the records, and these are checked to see how they have been taken care of. The bank observes whether or not the depositor has been entirely out of debt to the bank for a reasonable period during the year, for it considers that this provision insures the liquidity of its assets and indicates that the funds are being put to proper use by the borrower.

The Character of the Loans and Discounts.—The records are examined to see the character of the loans and discounts. The amount borrowed unsecured, and the amount secured are considered. The bank may open a secured or indirect line of credit in addition to the direct, unsecured line. This secured line may represent warehouse receipts discounted with the bank, customers' notes taken in due course of business, endorsed, and discounted with the bank, or it may be customers' accounts receivable put up with the bank. The amount of this indirect borrowing is taken into consideration when the limit of direct borrowing is being established. When notes of customers are discounted, the number of them protested is looked into to see how reliable the borrower's customers are in meeting their notes, as reflected in the record kept by the bank.

Renewals.—The essential consideration in connection with a concern's assets is its power of self-liquidation within a reasonable time, for the banker is interested in knowing that the customer can pay his loans from the normal revenues derived from operations.

When checking the record of loans made in the past, the payments are studied to see how the notes have been taken care of and the number of times the customer asked for renewals. Constant renewals without obligations being cleaned up, or liquidated only in part, indicate financial weakness. Also, the bank insists that notes falling due shall be either renewed for a reasonable time or paid off, in part at least, on the day they fall due, depending upon the circumstances of the case, unless there is a sufficient reason and the bank is notified. No bank wishes to carry past due paper, and the reaction, of course, is unfavorable when the borrower fails to look after his notes promptly.

In judging the past relationship with the bank the length of time the borrower has been in business is taken into consideration, and also the length of time he has carried his account

at the bank. Because many young businesses are started with limited capital, not infrequently they will be found to suffer from "growing pains." They develop so rapidly that their cash resources are not enough properly to finance their sales or production. It is obvious that with the financial structure of the enterprise out of line, bank obligations are difficult to liquidate. Loans are made and renewed again and again, so that the bank is practically furnishing working capital for the concern. In making the internal investigation this tendency is taken into consideration, and depending upon all the circumstances of the case, a bank may curtail its credit owing to the unreasonable and persistent borrowing, inconsistent with the financial standing of the beneficiary.

Interest Paid the Borrower on Balance.—The amount of interest paid on balances is likewise considered. Some authorities are of the opinion that the nature of commercial banking is such that banks are sometimes unwarranted in paying interest on commercial deposits. Such funds being subject to immediate check do not always afford the bank an opportunity to make any profit on the account owing to the activity of the account and the cost of handling it. However, the competition for valuable accounts is such that in large financial centers particularly, the payment of interest on commercial balances that warrant it is well-nigh universal. Yet, offering interest on balances before analyzing the account is not considered safe procedure.

Borrowers are expected to keep compensating balances on deposit with their bank to the amount of 20% of their loan. If they are not borrowing, they may expect to receive 2% interest on their average balances in excess of $1,000. Their past relations with the bank, and the result of the analysis of the account, will be a big factor in proving whether a bank can afford to pay any interest or not.

Among other things, the amount of float on checks going

through, that is, the time they are outstanding before the bank gets the money on them, is considered and has a direct bearing on the interest question. Also, the number of items drawn each month against the account, and the overhead must be considered.

If, after making an accurate analysis, the bank feels it can afford to pay interest to the commercial depositor, it does so. Otherwise it will not. It may here be observed that if some of the rural banks in the far west ask 7% or 8% interest on the money they loan out, it would seem logical that they could afford to pay at least 2% to their clients. The fluctuating nature of commercial deposits, however, will always make the payment of interest on deposits inadvisable from a strictly banking angle, and banks will find it to their advantage in the long run not to pay, if they would curb competition for accounts and cease offering interest rates they are in some instances unable to earn.

The usual rate paid on commercial deposits, as already stated, is 2% on all balances above $1,000, and in many instances this rate is the one agreed upon by the local clearing houses. In some localities higher rates are paid, but usually the borrower, while receiving the benefit of higher interest on his deposits, pays heavily for this consideration when he makes a loan and finds he must pay a stiff rate for the money he borrows. The law of supply and demand plays a part in determining what rate the bankers are willing to pay for deposits. It is logical when deposits are hard to get that the banks should bid higher for them; on the other hand, when money is cheap, the banks are not so anxious to pay interest, as they realize that their borrowing customers will expect low loaning rates, and the banks in consequence will not be in as good a position to pay a high rate of interest in return for deposits left with them.

Interest Rate Charged the Borrower.—The record of the interest rates charged the borrower is investigated. The inter-

est rate charged is based upon the going rate for the "over-the-counter" transactions in the great financial marts of the world. Unsecured loan rates are unquestionably influenced greatly by the discount rates set up by the Federal Reserve Bank, by local conditions, and personal factors entering into the particular transaction. It is not the purpose of this discussion to go into detail regarding the reasons why money rates fluctuate, or to go farther into the subject than to outline some of the reasons why the banks establish different rates for different accounts, and how past relations with the bank may have some weight in the matter.

Bank loans ranging from around $500 up to $1,000 often will carry a 6% interest rate when the market may be only 5%. This is because it costs the banker a certain amount of overhead to handle the small loans, and often as much as large loans. The bookkeeping, printing, and other fixed charges make it necessary for a bank to stiffen the rate for the small loans in order to come out with a fair profit. Loans for several thousand dollars will generally carry the going rate charged by all the banks.

When borrowers continually complain about interest rates charged, or are always trying to get the banker to cut his rates in their favor, they usually injure their standing with the bank. If records show an unwillingness to pay the fair market rate, then the banker does not care to grant accommodations.

Depositor's Financial Standing Affected by His Blunders.—Let us now take up some of the common blunders made by depositors and see how they influence the banker's attitude in making his internal investigation. Few depositors realize that temporary obligations running up into the millions are created by overdrafts—by checks drawn against uncollected funds. Yet, when customers are careless in their banking habits, they unwittingly put themselves in the class of the ignorant and the dishonest; and while the banker would like to

give them the benefit of the doubt, frequent errors without excuse give the banker an unfavorable impression of the business ability of the prospective borrower or depositor, and influence him greatly with regard to the extension of credit.

Sometimes one wonders whether the banker's attitude toward the customer is more safe than human—whether he is more conservative than he is sympathetic; more selfish than altruistic. These questions cause one to inquire whether human relationships are essentially any different in banking from those in any other line of business activity.

The true position of the banker can only be appreciated by putting one's self in his position and by shouldering, for the moment, some of his responsibilities. Of all the common blunders by which depositors destroy the banker's confidence in them, the overdraft is the most reprehensible. A more amplified discussion of overdrafts will follow later, but at this point it is desired to stress the effect they have on credit relations.

The importance of carrying good bank balances has already been mentioned, but it is essential for the borrower to put himself in the position of the banker who is dealing with an individual or corporation which not only does not carry a valuable deposit, but draws checks without having funds in the bank to meet them. Some of the reasons why the overdraft is so damaging to an individual's credit standing will indicate its importance in the borrower's past relations with the bank.

1. When a depositor draws a check, knowing that he has no funds in the bank to meet it, he in reality is forcing his banker into a loan without asking for it. The banker has so many of these habitual offenders to check up each day that to see a name on the list of overdrafts injures the man's credit standing, unless he can clear himself later with a good explanation. Why, it may be asked, is the banker so adamant in his attitude toward the overdrafter? The answer is manifold, and further explanation is needed.

2. Because of the crooked element in every bank's clientele, the unintentional overdrafter, in spite of himself, is thrust unceremoniously into the class of those who are out to "work" their bank for a loan without asking for it; and often without any intention of ever paying it back. The overdrafter is too often an individual who has moved out of town without leaving an address.

3. In a previous chapter the part business capacity plays in credit matters was discussed. Naturally, if an individual or corporation overdraws the account continually, the banker will not have a very good impression of his ability. It is only a careless person, or one with a poor bookkeeping system, that is found guilty of this offense.

4. Lastly, there is the case of the honest but ignorant person who does not know how serious it is to overdraw one's account. Take the college youth who has never had a checking account. If he expects assistance from his banker in establishing himself in business, he should be careful in looking after his account. His ignorance may save him from his being put in the dishonest class, but a continuation of the offense will injure his credit with the bank. If the innocent offenders appreciated the truth of the statements made above, they would make a clear explanation to their banker of how they happened to overdraw their account, and do so as soon as they have learned of their mistake, and not a week or more later, as is too often the case.

Drawing against Uncollected Funds.—When companies are just starting in business and capital is limited, it is obvious that at certain periods of the year their bank balances fall off. Indeed, it is not an uncommon occurrence for an operator to find himself hard-pressed to meet the weekly payroll. The firm or company may have some checks coming in, and these are deposited with the bank. But before they have had time to clear, the depositor wishes to draw against them to meet the payroll. In other words, he wants to draw against uncollected

funds. Since the banker has not as yet received the money for the checks, it is obvious that to allow checks to be drawn against uncollected funds, practically amounts to a temporary loan. The banker is reluctant to do this, for the reason that a company short of working capital is not a very safe risk, and hence money paid out may never be recovered; besides, it is not considered good practice.

Effect of Uncollected Funds on the Banker.—The mistake the needy company or individual makes, as far as his future credit standing with the bank is concerned, lies in not telling his banker frankly of his financial condition. When the bank official knows all the facts, and feels that the management is deserving and honest, he sometimes encourages them by allowing them to check against their uncollected items until credit arrangements can be made and their pressing obligations can thus be met.

When in 1925 thousands of persons entered Miami, Florida, to engage in real estate and other activities connected with the boom, they often brought cashier's checks with them. Upon arrival the first thing they did was to go to the bank and open an account. "Here is a cashier's check for $1,000," they would say. "We should like to open an account with a part, and draw a part to meet our current expenses." The bank, not having banking connections with the parties, could only reply: "I would like to do this for you, but unfortunately, we will have to wait until this check clears before we can allow you to draw any checks against it." There were so many cases of this nature that the banks of the city, by mutual agreement, made it a rigorous rule not to permit drawing against uncollected funds. Heavy losses through fraud were thereby prevented.

To press the banker for permission to draw against uncollected funds does not aid one's future chances for credit. It is apt to leave the banker with the feeling that the individual does

not do business on a strictly business-like basis and is inclined to sharp practice.

The Practice of Check-Kiting.—In this connection, it is well to explain check-kiting, since it is closely related to the question of uncollected funds. There are a great many half-crooks who are depositors in banks, people who manage to keep within the law, but with whom bankers have had unfavorable experience in relation to checks. They will use two banks. They will draw a check on one bank and then on the other, and keep juggling their accounts without funds in either, and this at the expense of the banks which, if not on their guard, are making payments against uncollected funds.

Individuals practicing check-kiting take an unbusiness-like advantage of their banker. In operating they draw a check on a bank for an amount greater than their balance, and before the check they have drawn has had time to clear, they make a deposit of a check or checks to cover the face amount of the check drawn. Often in making such a deposit to cover they will draw a check on another bank with which they have an account, but in which also they do not have the amount of the checks drawn. Thus the check-kiters seek to use checks on one bank against those on another without having any appreciable amount in either. Sooner or later, however, the banks learn of the check-kiters' dishonest practices, and the accounts are closed out without further ceremony. A reputation for kiting checks naturally precludes the possibility of opening credit relations with a bank; and it is a strange fact that some business executives under financial pressure sometimes resort to this practice, failing to appreciate the disastrous effect it has on their relations with their bank.

Post-Dating Checks.—The internal investigation of a borrower's credit standing may show a record of unnecessary post-dating of checks. When individuals are in the habit of

post-dating checks, even though thoughtlessly, it gives the impression that they are careless business men. Consequently, such practice does not help their credit standing with the bank.

Post-dating a check consists of dating it ahead and amounts to an acknowledgment of indebtedness. It is inexcusable, and results when a creditor feels doubtful about the borrower's ability to pay his obligations.

A banker is not impressed by a record established by a customer for post-dating items. When such is the case the banker, in considering an application for a loan, takes the post-dating individual's propensity as evidence of his lack of capacity for business, and it does not strengthen the latter's appeal for a line of credit.

Stop-Payment.—Another unbusiness-like practice of depositors creating an unfavorable record is that of stop-payments. A client makes out a check in payment of some obligation, but changes his mind and calls upon his banker to stop the payment of the check. Sometimes the item has passed through the hands of several innocent holders for value, who have taken the check in good faith for value received.

When one sees the work the stop-payment entails, and how it imposes on the banker considerable loss of time and a good deal of trouble, some idea can be had as to its effect on one's credit standing. Here is what the banker does when he is asked to stop payment. He fills out a stop-payment notice and turns it over to the bookkeeper who attaches it to his sheet in his ledger book. When the item comes back for payment it is turned back unpaid.

It can be seen that the banker, to protect himself, must have a written confirmation on a stop-payment, for otherwise he would be liable to be sued for non-payment. Numerous law suits have resulted against banks because of their zeal to protect their depositor's interests in this respect, and in certain in-

stances the decision was against them. For this reason bankers do not look with much enthusiasm upon stop-payment orders.

Obviously, a person or firm having a weakness for making unreasonable stop-payments will not be regarded by his banker as a very safe subject for a loan. Indeed, the banker might well question his business ability. Occasionally, cases arise which involve the bank in an altercation between two depositors, one asking for payment, and one for a stop-payment. In such circumstances the bank follows the written instructions of the maker of the check and when due diligence is used, is protected on stop-payments.

Gratuitous Services and the Borrower.—Lastly, there will be considered the matter of gratuitous services performed by the bank in the past. Some individuals or corporations carry negligible bank balances, but consume hours of bank officials' time on trifles which they could just as well attend to themselves. There are some who would have their banker conduct their business for them; but as bankers are forced into more businesses than they wish, due to defaults on loans, it is obvious they hardly care to go beyond their legitimate banking functions in assisting their depositors in their business.

In determining the interest rate on a loan application and in estimating the costs on collection items deposited by the borrower and the discounting of his paper, the banker takes into consideration the gratuitous services he has rendered the depositor. If he is to operate at a profit he has to pay attention to the extra services incident to the handling of the account; and while it is said that all a banker has to sell is service, still that does not mean that he is conducting an eleemosynary institution.

Written Memoranda of Interviews between the Borrower and the Bank.—The most direct source of information to the bank is the applicant for the loan himself. The prospective borrower furnishes directly certain information which the bank

officer verifies through interviews at the bank and on visits to the customer's plant or office, and supplements by reference to the sources already discussed, and those outlined in later discussion.

The Value of the New-Business Department to the Bank Credit Departments.—When the representatives of the new-business department or other employes of a bank are seeking new business for the institution, they should be of valuable assistance in securing internal credit information concerning prospects, and the bank's customers called on for leads.

Nowadays, banks believe in the value of new-business men from more than merely a new-business angle. These men accumulate facts regarding the business firms in the vicinity of the institution, and in the case of the largest banks, secure information regarding the financial condition of industries all over the world.

When the new-business representative makes a call on a prospective client, his investigation covers the following scope, in collaboration with the credit department. He meets the president and the other important officials of the company, and is able, during the course of the conversation, to learn something of their character, habits, and knowledge of the business. He often receives an invitation to inspect the plant or establishment, and in so doing is able to draw some conclusions regarding the efficiency of the management, the value of the physical properties of the company, the character of the personnel, and the business methods used in manufacturing or handling the product. He frequently is asked to look over the balance sheet of the company, and without in any way committing the bank, is able to get an excellent idea of the financial strength of the prospective concern, and to form some judgment of its financial program and its future prospects.

Armed with the data he has accumulated, the experienced bank representative returns to the bank and dictates a memo-

randum of all the valuable information he has secured during his preliminary visit. He has ascertained the banks with which the firm does business, or formerly did business, the trade references, and other credit facts pertaining to the internal affairs of the concern. Each succeeding time he calls on the prospect, he gathers more information. He becomes familiar with the president's habits and hobbies; and frequent calls may lead to social engagements and wider contacts, which make for a well-rounded credit background.

The Value of the New-Business Department to the Borrower.—The value of the new-business man and his department to the borrower will depend upon the attitude the latter takes toward him. Take the case of a company which has recently moved into a new community, and desires to open an account with a local bank. The company borrows seasonally from its present bank, and on that account does not want to jeopardize its financial standing by making premature connections with some other institution. It may not absolutely need additional banking relations, and consequently wishes to know what it may expect in the way of accommodations from the new bank before opening an account.

When the new-business representative calls at the prospect's plant or office, he may not ask immediately for an account, but may introduce himself, and seek an interview for the purpose of getting preliminary credit information. During the course of what is often virtually a social visit, the banker is able to make a general survey of the internal situation. If the company appears to be a worthwhile prospect, the new-business representative may order, through the bank's credit department, an agency report on it from Dun's, Bradstreet's, Hill's, or some other commercial agency.

From the point of view of establishing the background for the borrower, the following benefits accrue in dealing with the new-business department of a bank:

If the new-business department has obtained a special agency report on the concern, the borrower has the advantage of being known to the bank from the start, as the report gives the antecedents and the condition generally of the company. In some cases the report will show a recent financial statement of the enterprise. This will prove an added advantage.

Often with the credit information obtained from an agency report a new-business man, upon instruction from the bank's president or the loaning officer, can make definite overtures, whenever he thinks advisable, to the executive in charge of the finances of a concern, regarding the matter of accommodations. When such is the case the work of opening a line of credit and the establishment of banking relations is greatly simplified. There remains only a verification of the facts as already outlined in the report, with the additional trade and other checkings from banks and other sources, to enable the discount committee to pass on a line of credit for the borrower.

When the prospective customer is invited to call on the loaning officer or president, and the credit department in co-operation with the new-business department, has furnished the latter with the necessary credit information in advance, a closer contact is established, and the questions involved regarding the conditions of the loan are more quickly settled to the satisfaction of all parties concerned.

In many instances the borrower will enjoy a better introduction as a result of the efforts of the new-business department to establish his position as an applicant for a line of credit, than would be the case in an introduction by a customer himself, because the bank, in making its investigation, may have a more thorough knowledge of the risk as a basis for opening negotiations.

Another advantage, from a credit angle, enjoyed by the prospective borrower in doing business through the new-business department, lies in the fact that he opens negotiations with the bank in his own office. He can offer his account to the

bank on the basis of accommodations to be granted, and if relations are not established, the borrower has not deviated greatly from his former procedure or lost much time in the exchange of confidences with the banker.

When the borrower has the new-business officer as his guest, he also is in a position to exert the force of his personality to the advantage of establishing confidence. Again, the applicant can take the new-business representative through his plant, discuss with him his internal problems, the way he conducts his business, and in this manner is in a position to inform the bank representative of his ability as a successful operator.

From the point of view of enlightening the bank concerning business policies and procedure, there are also advantages gained by the borrower. He can show how his books are kept and point out the original entries showing his accounts receivable, where it seems advisable to do so. Thus the alert new-business representative, in co-operation with the credit investigator, secures essential internal information concerning the plant and the management of the business which is valuable to the credit department in establishing the background of credit.

CHAPTER IV

EXTERNAL INVESTIGATION THROUGH BANK CHECKINGS

Importance of Bank References in Making Commercial Loans.—Owing to the character of their business, banks co-operate with each other in credit matters possibly more closely than is true in any other line of human activity. The reasons for this are important from the standpoint of their relations with borrowers.

1. Since the bank is loaning money on an unsecured basis, and has nothing more than a promise to pay, it is compelled to co-operate to the fullest extent with other institutions and determine as accurately as possible the value of the promises made.

2. The confidential nature of the banking business enables banks to secure an accurate check on borrowers in their previous relations. The cardinal principle of bank credit investigation is to keep absolute secrecy in all replies. The banks have followed this policy to protect themselves and their clients for so many years that they are generally considered to enjoy an unusual advantage in the exchange of credit information. But at the same time they have been thought somewhat disappointing as co-operators on the part of commercial houses seeking credit information.

3. The character of borrowers' past banking relationships is a good indication of what to expect for the future. The chances are that a firm with an established reputation for being slow in meeting its obligations with one bank will prove to be the same when it has established new banking relations. Since experience has shown this to be true, when banks receive an

unfavorable reply to inquiries sent out regarding an applicant for credit, or in connection with opening a new account, they often close out the account without waiting to find out whether the individual has changed his business methods.

4. Because all conservative banks are working toward mutual protection in making commercial loans, they have come to lean more heavily upon each other and often base their opinion of a risk directly on a communication from some friendly bank which has frankly given them its previous experience with the risk.

5. Banks, because of their close fiduciary relationship, often go more into detail regarding the financial condition of their unsecured borrowers, and thus their interchange of credit information is possibly more complete and reliable than that between commercial houses.

All these factors tend to make bank checkings, next to the financial statement, one of the most important and valuable sources of credit information concerning a borrower.

When Banks Exchange Credit Information—Letter Sent Out on New Accounts.—Often when a firm opens an account, the banker will ask not only for the name of the previous bank, but for any other banking relations it may have had since it has been in business. The bank sends out a letter, similar to the following, used by a middle western bank, to these institutions, stating that the individual or concern has opened an account and that any information available concerning their experience with the subject would be appreciated.

Gentlemen:—

Mr..... has just favored us by opening a personal checking account, and informs us that he has done business with your bank.

Will you kindly give us in confidence such information as you may have regarding his character, financial responsibility, etc.?

Anything you tell us will be very greatly appreciated, and we shall be glad of an opportunity to reciprocate at any time.

Very truly yours,

Enclosed stamped envelope.

Manager Credit Dept.

Since no reference may have been made to establishing credit relations at the time the account is opened, it is possible that the bank written to may reply briefly that the party is responsible, but does not go into detail regarding that party's financial standing or its previous loaning experience. The letter sent out upon the occasion of the opening of a new account is of relatively little use for credit purposes unless specific information is elicited regarding the applicant's eligibility for a bank loan.

Letter Sent Out in Connection with a Loan Application. —When the loaning officer is approached for accommodations, he wants to know the extent of the prospective borrower's past banking relations, the names of the banks, and what the character of the former transactions was. To check up this information he sends out a letter similar to the one shown below, which is used by a middle western bank.

John F. Jones & Company,
Boston, Mass.

Gentlemen:—

If known to you, will you kindly advise us regarding the credit standing and financial responsibility of the Blank Mfg. Company, 1423 Robey St., Boston, Mass., and the condition of their business at the present time; also respecting the character and efficiency of the management, as they have opened negotiations for a line of credit with us and we are writing to supplement our files with your experience. Are they honorable, capable, progressive people, whose obligations are regarded as a first class banking risk?

Anything you may be pleased to tell us regarding this concern will be very much appreciated and held strictly confidential.

Thanking you for your courtesy, which we shall be only too pleased to reciprocate, we are

Yours very truly,

Assistant Cashier.

Enclosed stamped
envelope.

If the applicant has never made any previous requests for credit from any bank, the replies to such a letter will not be

very much in detail. Just as there are merchants who have good customers who buy steadily but whose names do not even appear on their books, because they always pay cash, so the banker often has depositors who are valuable clients, but merely use the bank as a depository and have had no occasion to establish their credit standing with the bank. In such cases the bank has to rely much on its internal relations with the customer, and study the manner in which he has handled his account.

Letter Sent Out to Revise the Files.—The following letter is one sent by a middle western bank in connection with revising its files.

Mr. James Jones,
Manager, Credit Department,
X National Bank,
New York City, N. Y.

Dear Mr. Jones:—

If known to you, will you kindly advise us regarding the credit standing and financial responsibility of John Smith and Company, 360 North Michigan Avenue, Chicago, and the condition of their business at the present time, as we are revising our files. Also respecting the character and efficiency of the management. Are they honorable, capable, progressive people, whose obligations are regarded as a first class banking risk?

Anything you may be pleased to tell us regarding this concern will be very much appreciated and held strictly confidential.

Thanking you for your courtesy, which we shall be only too pleased to reciprocate, we are

Yours very truly,

Enclosed stamped envelope.

Manager Credit Dept.

Bank checkings are also important when it is necessary to revise the credit files. The revision may be the annual one customary with most well-conducted banks, when there are financial changes, and up-to-date checkings and fresh information are an absolute necessity. An indiscriminate checking of names is considered unethical and unnecessary. Relations with a borrower may be long established and highly satisfactory;

still, the bank wants to keep its files up-to-date and know the current opinion of its fellow bankers regarding the risk in cases where it is felt unquestionably desirable to do so. Again, where increased lines of credit are sought, the bank may wish to safeguard itself by securing bank checkings to date, especially where the borrower uses several institutions. New checkings may also be thought advisable when it is necessary to know how much the other bankers are doing in the way of loans, or when it is thought advisable to check back on certain information disclosed by the borrower which has a bearing on the risk.

Obtaining Credit Information Through Domestic and Foreign Field Men.—Banks obtain helpful information through their domestic field men, who are experienced investigators, skilled in securing facts relative to the credit standing of individuals and corporations. In the foreign field the credit departments and field men of the branches of the banks are the most useful sources of information, and this is supplemented by correspondence with affiliated banks with which some confidential relationship exists.

Obtaining Credit Information Through New-Business Department.—When soliciting new business involving a line of credit, the new-business representative is expected to cooperate with the credit department in determining the prospective borrower's past banking relations. He obtains the names of the institutions with which the applicant has had former relations, and may be called upon, in some instances, to make a personal visit to the loaning officers or credit men of these banks for their experience regarding the subject.

In some negotiations it is to be expected that the financial head of the prospective borrowing concern does not want to disturb his present banking relations until he knows precisely what he may expect in the way of a line of credit from the new bank. Thus the bank representative is asked to hold off writing

the banks until the very end. If the trade references are not satisfactory and negotiations are not consummated, present banking relations are not disturbed. By handling the situation through the credit and new-business department, skilled in investigations, no danger will thus be encountered in negotiating for a line of credit with a new bank. If he is rejected by the soliciting bank, the prospect is not left without any banking connection as frequently happens when, through his own ignorance, or the indifference of the soliciting bank, bank references are written too prematurely.

When a prospective borrower gets to the point of having an investigator from the soliciting bank go to his present banking connection for information, it is advisable for him to protect himself as far as possible. This he can do by asking the soliciting bank to have some correspondent bank send a representative to get the facts regarding his present banking relations. When the information is sought by this indirect method, it does not have the same damaging effect it would have if the soliciting bank went direct to the other bank and discussed the possibility of transacting business with the prospect. There is no need of alarming the bank from which this information is sought, by the thought of losing a depositor, for if the customer has decided to change because of more satisfactory arrangements that he can make, he will change and nothing can be gained by causing the friction which direct inquiry often creates. Obviously, if the soliciting bank's representative finds it necessary to go direct to the other bank, the only thing he can do is to state frankly the nature of the call, and take his chances on securing the desired information, and on the other bank's not bringing pressure to bear on the customer to keep his account with that bank.

Credit Information Sought From an Out-of-Town Bank. —Great care should be used, when an inquiry is sent to some out-of-town bank, to address the particular officer of the bank

from which the information is sought. Too often the borrower, when naming some out-of-town bank as a reference, with which he did business some years ago, fails to tell just what the nature of his banking relations were, and the letter the loaning officer or credit man sends out is often too general in character. As a result when the reply comes back, it is not very helpful, as the banker answering the inquiry may not have known in just what connection the information was being sought. The borrower should therefore, be specific when giving a bank reference, not only naming the officer with whom he transacted his business, but also stating just what these banking relations were, whether firm or individual, and whether or not favors were asked and extended. Such information will help the present bank to obtain the pertinent facts which will increase the loan applicant's chances of receiving the accommodations to which he is entitled.

Bank Credit Department and the Commercial Borrower. —The credit departments as they are seen in banks today, were not known 20 years ago. Their widespread use is a matter of comparatively recent development. The heavy demands put upon the loaning officers, owing to the growing complexity and intricacy of the banking business in the past few years, have made it necessary to have a department to relieve them of the detail connected with establishing the financial background of the borrower. Thus in most well-managed banks, and in an increasing number of small ones, we find a man whose sole duty is to seek credit information, and to organize it for the use of the loaning officers, in the first instance, and the discount committee subsequently, if the loan applications get that far. It is only natural that the organized credit department should be able to make more comprehensive credit investigations than a loaning officer who is all day under pressure at his desk from a succession of loan applicants, and who finds it difficult to spend the time necessary, along with his other duties, to procure the

credit facts in sufficient quantity and quality to make possible a sound adjudication of a credit application.

But the advent of the credit department as a permanent division of a bank not only proved a good thing for the bank officials, but made possible also closer and more intimate relations with depositors and prospective borrowers. For the individual or firm seeking a commercial loan the credit department can give close co-operation in the following ways.

The Time for Investigation.—In the first place, an organized credit department has the time to search for the credit information desired. Since this division of the bank is devoting all its time to this work, it can go more thoroughly into the applicant's request for credit. It has its clippings, its rating books and its investigation sources to draw from. It can pry into more angles of the risk's application for credit, and analyze more accurately the data submitted, and hence be of greater assistance to the inexperienced borrower, who is not familiar with the steps taken by banks in establishing credits. Often the preparation of credit data has much to do with the impression it has on the recipient. Hence a borrower has a better chance of getting a fair consideration when the credit end of a bank is functioning properly.

A Convenient Place for Investigating.—The commercial borrower is also more favorably placed when a bank has a special department with private rooms for investigating prospective borrowers. It takes space to house the instruments of credit investigation. When ample quarters and facilities are provided, they make for sound credit commitments by reason of the concentration of forces made possible. It is essential that a credit department have ample room for its files, its clippings, its credit reports, its rating books, and the members of its staff. Privacy makes for more careful analysis, more thorough study, and more careful preparation on the part

of those responsible for the shape in which the applications come up for consideration before the loan committee.

Organization to Carry on the Credit Investigation. —The larger a bank is, the more assistance the credit manager will have to have to do justice to the loan applications sent in for investigation. With assistants to help compile the data, investigators to run down the facts, and clerical help sufficient to give quick service in getting out the correspondence, the credit information will be the more complete. When the credit manager can send out men, to make inquiries personally from the banks and the trade, the borrower has a chance of getting his standing checked first hand, and all the intimate sidelights on character are brought into the picture when the application for a loan comes up for consideration. The more complete the organization of the department, the more complete the credit files should be in establishing the character of the risk. This means a fairer treatment of the borrower. He will be sure of getting a fair decision when the organization is prepared to make a thorough investigation and establish the facts.

Other Services Performed by Credit Department.— Although it goes without saying that it costs money to investigate a credit risk, still, the commercial borrower often fails to realize the expense a bank undergoes in getting to the bottom of some of its credit problems. It means expense to make extensive credit analysis. The salaries of those in the department, the time it takes to do the work all must be taken into consideration. By having a department especially provided for credits the bank is doing a number of things for the borrower. In reality, it is setting aside a certain amount each year to give the applicants for credit a fair chance. It costs the bank money, but it places the borrower in a favored position. It makes him realize that it is thorough in the things it undertakes, and just in its credit commitments. The credit department

safeguards the interests of the bank and the depositor also, as it makes for conservation in matters of accommodation. The detailed analysis made possible by the organized, well-equipped department often helps the client to work out financial solutions which obviate the necessity of loans. Frequently, too, the credit department will disclose conditions which, when pointed out to the depositor, lead to greater financial progress and more substantial profits.

Reasons for Loan Refusals.—Bank checkings are not final in considering loan applications, but they often prove so vital, so good an indication of the financial character of the prospective borrower, that the banker is often greatly influenced by them in deciding whether or not to grant accommodations. Some of the reasons why banks refuse to grant lines of credit on the unsecured basis may be mentioned here:

1. The bank may decide that the applicant does not really need the loan, and that he will be better off if he does the financing without borrowing. Under such circumstances he will probably receive from the bank some very good counsel which he should make the most of.

2. The decision may be that the business is of such a type that if accommodations were extended, there would be little likelihood of periodic liquidation, even though the borrower might be able to pay the loan off at maturity. This would apply to a steady, "all-year-round" business, such as is found in certain types of retail trade. Under such circumstances the bank might advise the borrower to supply himself with the necessary "permanent" working capital by securing a larger investment from the proprietors or stockholders.

3. The bank may decide after investigation that the business itself is too great a risk. The type of business may be one with which the bank is not acquainted, though some other banks may be more familiar with the line of business and might be willing to "take on" the account. In the event that no bank

could be found to extend accommodation, the company's only alternative would be to raise working capital by selling more stock or reinvesting its earnings.

4. In some instances the bank may not approve of the management or the managerial policies of the company and hence may not care to be connected with the business.

5. Again, the purpose of the loan may not meet with the bank's approval, such as its investment in permanent or non-liquidating assets, or for purposes foreign to the objects of the enterprise.

6. In the course of the investigation the bank may have found a lack of frankness and willingness on the part of the applicant to supply necessary information. This might cause the bank to refuse the account even though no actual deception had been practiced. At times, however, it is found that the applicant has actually misrepresented his condition in such a manner that he is not regarded as a desirable "moral" risk.

An Analysis Showing Importance of Bank Checkings.— An analysis of 50 companies, whose loan applications were rejected by discount committees of banks throughout the country recently made by the writer reveals the significant part played by bank checkings in the granting of accommodations. The results were as shown in the table on page 390.

Nine of the 50 offerings were refused because of unsatisfactory bank checkings. Hence, nearly one-fifth of the firms, even though they had a working capital ratio of better than two to one, were shown to have some inherent financial weakness revealed by the checkings.

While there were other causes, besides those tabulated which influenced the discount committees in their decisions, the ones in the table on page 390 taken in the light of all the circumstances in each case, were the deciding factors for rejection, and as such are of interest to the commercial borrower and the banker.

In checking these 50 companies letters were sent to the banks given as references, and the replies supplied the following information: In two cases the progress of the concerns was not as healthful as should be. Two other firms had lost considerable money during the past two years, which was not shown in their statements. Another company had large amounts due in the form of receivables from companies going through receivership. Another concern was found to be a slow pay.

It can be seen from the above that the importance of using bank checkings, to verify the assets shown in the balance sheet, cannot be over-estimated. They undoubtedly prevent heavy losses to the banks, aiding them to distinguish the good risks from the bad. By reading bank and trade checkings carefully, and considering from whom they come, the banker is able to make sound credit decisions.

Checking letters received from banks occasionally leave the banker with the impression that the corporation's finances are so involved with those of other companies, that its status is difficult to determine. Rather than thrash out the situation, which sometimes takes an infinite amount of time and expense, the bank rejects the loan application at the very outset on the basis that it does not care to become too involved in its relations with its clients, nor take a chance on a company which might ultimately prove to have less assets than was at first supposed. Thus it behooves a prospective borrower to outline clearly in writing or in an audited statement all the facts regarding its financial backing and the previous banking and other connections of the concern, so that the banker does not have to take too much time in getting to the bottom of the situation.

CHAPTER V

TRADE REFERENCES, MERCANTILE AGENCIES, AND CLIPPING BUREAUS

Another important step in securing the proper consideration of the banker in loan matters is that of furnishing adequate trade references. From those who buy and sell merchandise or who have other business dealings with the applicant for credit, the banker expects proper checkings before he commits himself in the matter of unsecured accommodation. Indeed, those who sell to the borrower under investigation have the same problems confronting them as the bank has, and a knowledge of the circumstances under which they extend him credit is valuable. Likewise competitors and others who may not deal with him direct are in a position to give the bank accurate information as to his standing in the trade. By exchanging information with certain of the large commercial concerns the bank is enabled to obtain very close and reliable information as to the business ability and integrity of the subject, as well as the credit rating which he enjoys among his business associates. It is, therefore, important to examine carefully the relation of trade checkings to the commercial borrower that some appreciation may be gained of the banker's attitude toward him in the adjudication of credit.

Trade Checkings vs. Bank Checkings.—It has already been pointed out how heavily the banks lean on one another for credit information, and how seriously they take the written or spoken word of a fellow banker in passing on the credit standing of a prospective borrower. When an applicant for credit has a reputation for being slow pay with his banker, he is not

in a strong position to obtain accommodations. Banks are not accustomed to recommend depositors to other institutions for credit if the depositors do not live up to their obligations. Bank checkings are of more weight in their effect on an applicant's credit than are trade checkings. When a borrower has a reputation for being unreasonably slow in paying off his loans, it does him much more harm, from a banking standpoint, than is the case in trade checkings. It is because the nature of the banking business requires reasonably prompt payment to maintain the liquidity of the bank's assets. This is more important to a bank than to a merchant, because the depositors have a claim on the demand deposits of the bank which they can exercise without notice.

In the case of trade checkings a company may be slow in some seasons of the year when its obligations are heavy, and at other times it may be in a position to discount all its bills. If it is well regarded and shows a good financial statement, the bank might be lenient with it, and grant a line of credit. Very often, however, firms which are not in a position to take the discounts on purchases are usually short of working capital; and such conditions are usually reflected in their financial statement.

Banker Getting the Right Checkings.—One of the first questions the banker asks after receiving a statement from an applicant, is, "Have we any trade references on you?" The applicant may have entered the names of the principal firms with which he has been doing business on the back of the financial statement form he has filled out for the bank. If not, he gives a list of them to the banker.

The question often arises, how many trade references are necessary? This depends in some instances upon the size of the company and also upon the number of concerns it buys from. But the usual minimum a bank asks for is a list of four concerns from which the subject has made purchases. Occa-

sionally the borrower will give but three or four names, and when the credit department sends out a letter of inquiry similar to that outlined in the previous chapter, the names or addresses of two or more are found incorrect, due to careless spelling, or the poor memory of the applicant, who is in too great a hurry to turn in the list. As a result, the letters fail of a reply, thereby causing delay. In some instances bankers become so discouraged trying to help some ignorant borrower of small means in the matter of trade references that the credit problem is given up in disgust and the applicant is allowed to take his account elsewhere.

Why Trade References Go Wrong.—The prospective borrower should take care to give the banker a sufficiently long list of references so that allowance can be made for the following contingencies:

1. The credit department of the firm to which the letter of inquiry is sent may be very busy and the answer may be received too late to be of value.

2. The name of the person to whom the inquiry was addressed may be incorrect. This often means a deficient letter of information in return, often delay, and sometimes no letter in response at all.

3. The person addressed may not have been in recent touch with the applicant, as is too often the case, and his reply is inadequate, and often based on too old a checking to be of value to the banker.

4. There may be several firms given, which do so little business with the applicant that their reply to the bank is too brief to be of any value in establishing the financial standing of the prospective borrower. A poor letter of recommendation is worse than useless. The surest way to damn is to "damn with faint praise."

Such are the obstacles met by the credit departments of banks in their efforts to aid the depositor desiring accommo-

dations. When the borrower is careless in giving the banker his references, how can he expect to get a prompt answer to his request for a loan? Yet borrowers often desire to know within a week's time the banker's answer when the letters of inquiry may hardly have reached their destination.

Names Borrower Should Turn to Banker.—The borrower should turn in a well-balanced list of names. He should be frank in giving his banker not only some of those from which the biggest purchases have been made, but also some representing the smaller transactions. If all the names turned in are those of concerns with which the applicant has been prompt and there are others which are purposely omitted because of slow payments, the bank will ultimately find this out through the mercantile agency reports. There is, therefore, little advantage in attempting to conceal the true situation from the banker by turning in a selected list of accounts, for when eventually the truth is known, the chances for getting a loan are diminished.

When submitting the trade names the applicant should give the name of the individual who is acquainted with the alleged business transactions and who knows, personally, the subject's financial standing, and is in a position to give the banker some useful information. Where concerns are given with branches in various cities, the branches and their proper addresses should be designated. The foregoing are minor considerations; but if prospective borrowers realized how significant they are in promoting credit relations they would give them more serious thought.

Value of Trade Letters to the Banker.—Inasmuch as the success of banking institutions depends in large measure upon the degree of efficiency demonstrated by their organizations in securing and skilfully using accurate credit information, it is little wonder that trade letters mean considerable to bankers.

In reading between the lines bankers become students of psychology. The phenomena of action and reaction, environmental conditions, all play a part in coloring the picture of the applicant's standing as a credit risk. Just how vivid this picture is will depend upon how apt the banker is in dovetailing together all the letters he receives.

Things the Trade Letter Tells Banker.—Among other things the trade letters usually give the banker an opinion of the character, responsibility, and business capacity of the risk which would not be forthcoming from any other source.

By way of illustrating their importance as an aid to the banker in making sound credit commitments, some examples of the replies banks receive to inquiries will be set forth: Here is a short paragraph—all there was returned—but see how potent it is:

"They discount all purchases of us. We think highly of them, as they are honorable and clean men."

Good pay and a high moral risk, apparently. The reply is good as far as it goes!

Again, consider this response to a letter of inquiry:

"Inquiries which we have made indicate that the concern and its management are very highly regarded by those with whom it does business. Trade requirements are extended in a large way and its bankers grant large lines of accommodation."

This letter came in from a banker who had checked the trade. It is valuable for its frankness and unreserved opinion of the risk, which indicate the prospective borrower's enjoying a strong financial position.

Bankers often experience difficulty in establishing a basis for credit from replies which are too brief and incomplete. If too much is left unsaid, then too much must be taken for granted to be safe!

The following reply came into the credit department of a bank some time ago, and is significant for its brevity:

"Sold since 1923
High credit $180
Owing 160
Due 160
Payments ..... 60 Days"

Such a showing as this is of but limited use as a means of establishing credit, and for this reason bankers encourage more detailed replies.

The Follow-Up Letter.—On page 47 there was given the type of letter sent out to obtain bank checkings. This same general type of letter is used by banks throughout the country to send to the trade.

Having sent out the initial credit letter, and after waiting a reasonable length of time for a reply, what then? Below is a well-rounded form letter which covers the points brought up in the first letter, refers back to the first request for information, and asks for an early reply. In some instances the first letter may have been lost in the mail, or may have been mislaid, or there has been some other inadvertence on the part of the credit department. Since the letter has failed to produce a response, a second letter is necessary. This reads as follows:

Mr. John F. Jones & Company,
St. Louis, Missouri.

Gentlemen:

Under the date of March 28, we wrote you requesting an expression of your opinion regarding the credit standing and financial responsibility of the Blank Mfg. Company. To date we have received no reply to our inquiry, and would ask that you kindly favor us with any information you may have and care to give us regarding the above company. Your response will be treated as strictly confidential.

Thanking you in advance for your kindness in this matter and with the assurance of our willingness to reciprocate at any time, we remain,

Very truly yours,

Assistant Cashier.

Enclosed stamped envelope.

If the individual or firm to whom this message is addressed does not respond, the banker will ask the borrower for further references.

Checking Up on Individual Responsibility.—It is natural to expect the borrower to be interested in seeking personal credit, and for this reason some of the steps taken by the banker to check the individual will be outlined. Experience indicates that an early response to a letter of inquiry is a reflection of the interest aroused in the party receiving it.

The following letter has proved helpful to a southern bank in checking up an applicant's personal responsibility. This letter reads:

May 1, 1925.

Mr. X. Y. Z. Credit Manager,
The X National Bank
or
The Y Company, if a concern
New York City, N. Y.

Dear Mr. XYZ:

Mr. A. Black has just favored us by opening a personal checking account, and informs us that he has done business with your good company (if a financial institution, *bank*).

Will you kindly give us, in confidence, such information as you may have regarding his character, financial responsibility, etc.?

Anything you tell us will be very much appreciated and we shall be glad of an opportunity to reciprocate at any time.

Very truly yours,

Vice President.

The reply to this letter gives the bank information on the previous banking relations, if sent to a bank, and information regarding the experience of the trade, if sent to a concern, and any information available concerning his financial responsibility. In many cases specific reference can be made to some transactions, loans, etc., which will be more definite, and will insure a more detailed reply.

A Credit File Revision Letter.—The indiscriminate revision of files, when there is no real need of information, is unnecessary and wasteful. Still, whether annually, or semi-annually, many efficiently managed banks have found it wise to revise their credit files. A credit revision letter is sent out to the trade as well as the banks, which states that the files are being brought up to date, and expresses appreciation for any opinion regarding the applicant's financial responsibility and the concern's experience with him.

This form of letter is helpful, and experience indicates that a ready response will be forthcoming. It builds up the bank's files regarding the risks, and often discloses valuable information for the protection of the bank. Following is a sample credit file revision letter:

John F. Jones & Company,
St. Louis, Missouri.

Gentlemen:

Some time ago you favored us with an expression of your opinion respecting the Blank Mfg. Company, 1050 Robey Street, Chicago, Illinois, and as we desire to revise our information at this time, we take the liberty of writing you again. If you know of any changes in condition, management, or other essential factors, we would deem it a favor to receive a word from you.

Nothing unusual or unfavorable is contemplated by this inquiry.

Anything you may be pleased to tell us will be very much appreciated and held strictly confidential. Thanking you for your courtesy, which we shall be only too pleased to reciprocate, we are,

Yours very truly,

Assistant Cashier.

The Fallibility of Trade Letters.—Wherever the human element enters into business we encounter the weaknesses which go with fallible human nature. Most borrowers try to do what is right when presenting trade references. Nevertheless, it is only natural that they should want to make a favorable impression when dealing with their bank, and so the tendency is to give the best trade references, and forget for the time being the poor or unfavorable ones. Naturally, this puts the

banker on his guard when considering the answers received from inquiries sent out; and he can hardly be blamed if sometimes he procures additional names in order that he may get as far as possible a well-rounded picture of his credit risk.

It can be seen from the above discussion how important it is to give the banker whole-hearted co-operation in the matter of trade references. By adhering to the principles outlined above, and by making an effort to keep the bank informed of one's relations with the trade, a basis of confidence is established between the banker and his clients which will make for sound commitments, and more liberal treatment for the commercial borrower.

Mercantile Agencies in External Investigations.—When a bank is contemplating extending credit to a commercial borrower, it is essential that the antecedents of the company be known and the responsibility and standing of the personnel. Because the mercantile agencies, Dun's, Bradstreet's and others, have become an important aid to the banker, particularly in large commercial centers, in their efforts to do justice to credit applicants, attention will be directed here at some length to the part they play in the external investigation the banker makes before granting a line of credit.

Importance of Borrowers' Giving Statements to Mercantile Agencies.—With the coming of the industrial revolution, and the building up in our country during the past century of a gigantic credit structure based upon promises to pay at a future date, there has been brought about a new era of credit relations; and today the most successful men are those who are most frank in their dealings, and whose business policies are based upon an open exchange of credit facts.

Because some commercial borrowers are still reluctant to give credit information to recognized mercantile agencies, and because in so refusing they often harm their own interests,

there will first be outlined some of the reasons why bankers consider it good business for commercial concerns to give a statement and credit information to mercantile agencies. Banks generally advise that every business man, whether buying or selling merchandise or labor, should recognize it as his social duty to furnish the other parties concerned with satisfactory evidence that he has the ability and the disposition to carry out his end of the business transaction.

The necessity for accuracy in statements requires the taking of periodical inventories and the keeping of an accurate set of books, resulting, for the merchant, in a better knowledge of his business generally and, therefore, more ability in its conduct.

Commercial agencies are not obliged to request from the merchant a financial statement unless asked by a banker who is trying to get information for extending a line of credit, or by the special request of some merchant. But out of fairness to merchants, who have so much at stake, they believe they should be given an opportunity to set forth their side of the case. The agencies have no financial interest in the matter, receiving a uniform price for reports, regardless of the size of rating and whether or not they contain statements.

A merchant submitting a signed statement creates a favorable impression by his frankness, indicating that he has nothing to conceal and that he has a proper appreciation of his obligation to those of whom he asks credit. The first thing which a credit man seeks in a report is the merchant's own statement, and its absence always causes a slight feeling of disappointment and, temporarily at least, a lessening of confidence.

Some merchants mistakenly feel that by refusing to give a statement, they are keeping their affairs secret. Such a refusal does not stop the investigation, though it may serve to handicap the reporter somewhat and cause some delay in getting

the information to the mercantile house or bank making the inquiry preliminary to granting a line of credit.

Since the credit agencies are determined, when called upon, to issue credit information, experience indicates that it is sound procedure to furnish them with complete information. By doing so business is benefited through the accuracy of the statements and the correctness which is insured when the information is given out direct to the agencies, as contrasted to the less valuable report which has been compiled from indirect sources.

Formerly, refusals to submit statements were frequent, but every year the number of business concerns so declining is becoming less. Today the leading business houses, after taking inventory, often voluntarily mail copies of their financial statements to their banks and the commercial agencies.

Bankers find that most merchants who are backward in furnishing them statements are much the same in their attitude toward the mercantile agencies. Refusals now come for the most part from the small merchants who have had little early business training, but with these it is largely a matter of education, and the credit man and the banker are in a position to give them valuable advice regarding such matters.

Obtaining Needed Information for Bankers and Borrowers.—The function of the commercial agency is simply to report conditions as ascertained from competent authorities and not to give advice or offer mere opinions. While necessarily the enemy of dishonest traders, it strives to act as a conserver of solvency and, so far as possible, to protect equally the interest of reputable borrowers and those extending credit. The correctness of information furnished is not guaranteed, but is submitted, without prejudice, as the honest result of faithful investigation. Obviously, the banker takes this into consideration when using this information in making loans.

The commercial agency's reporter visits the subject under

investigation and obtains, if possible, a signed statement of assets and liabilities, preferably from inventory, together with references, partner's or official's names, ages, if married, and as much contributory information as can be tactfully obtained. He then proceeds with the verification of the statement; not that the maker's veracity is questioned, but merely as a matter of business prudence.

He next examines the county records to see if the subject owns any real estate, if the title appears in his name or jointly with his wife or others, and the amount of any mortgages. He extends his investigation to any judgments, chattel mortgages, mechanics' liens, records of previous bankruptcies, and notes if any certificate of partnership has been filed, if the business is a partnership; and if there are any special partners, the extent and expiration of such special partnership. He next examines assessment rolls, and consults authorities on real estate valuations in the section where the property is located.

It is frequently found that real estate has been somewhat over-valued, which need not be taken as an evidence of deceit, but in some instances, more particularly in the case of residence property, may be attributed simply to sentiment. A man's home naturally possesses, for him, a higher value than it would for a real estate man concerned only with the money that might be realized from its sale.

Houses with whom the subject has had business dealings are also consulted as to the manner of the payments, their business methods, and impressions created by his dealings. The trained judgment of these houses is sought as to whether the subject is considered a judicious buyer, the amount and condition of his merchandise stock, his location, class of trade and prospects, etc.

Most concerns, when asked for references, usually name their bank first, stating that the banks are familiar with conditions and in a position to verify the statement in full. The

banker, as a rule, is possessed of very valuable information, of course; but on account of his confidential relationship with his depositors, is sometimes not able to be of as much help to the mercantile agency as he would wish. Thus the experienced mercantile reporter usually makes his investigation in all other quarters before interviewing the banker, using him to confirm rather than to advance information.

The commercial borrower is often surprised at the facts bankers have regarding them, but if he were familiar with the work of the mercantile reporters, he would not wonder. Investigation is made in all quarters, information being sought regarding the applicant's habits, social standing and business qualifications. None but reliable authorities are consulted, and the information furnished by each is closely checked up by opinions of others, allowance being made for differences in personalities.

If the subject is a newcomer, information is sought at his former place of residence regarding his history, standing, business qualifications and worth, while there, and a copy of the information obtained in current revision is forwarded for verification. If a statement and references are declined, investigation proceeds along the same lines, though the reporter may have to exercise a little more ingenuity and perseverance in locating persons who have had dealings with the subject.

How Mercantile Credit Ratings Are Determined.— Viewed from a bank-loaning standpoint, the credit ratings of a commercial agency are more important in informing the banker that the prospective borrower has enjoyed a credit standing in the past, rather than as having any great immediate significance. This is due to the fact that ratings change rapidly. The status of a firm may change over night, and mislead the banker were he to lean too heavily on a mercantile rating.

The assignment of ratings by mercantile agencies has a direct relation to banking credit, in that they are based upon

the financial standing of the firm or corporation. The requirements are rigid, and the closest scrutiny is made of the company's affairs before the mercantile agency lists the rating.

In the previous paragraphs the steps taken to secure information about a subject of investigation were described. When the proper replies have been received from these various sources, their substance is assembled in report form and the rating is assigned by men who have had considerable experience in that class of work and have a thorough knowledge of the particular field and its conditions.

In cities where reporting offices are maintained, a perpetual revision list is kept on the superintendent's desk, so that every case comes up for revision every 3 months. In the country the analysis is the same, as is also the procedure. The present system of revision is of comparatively recent date and was designed to keep the reports up-to-date. When a reporter visits a subject just beginning in business and he obtains a statement, makes the usual investigation, and writes a report, notations are made from his report and transferred to a file which contains 3 months' work. There is noted from the statement the amount of merchandise, cash, fixtures, real estate, accounts payable, notes payable, and any other items of importance, and on the back of the slip on which these notations are made, data gathered from 3 or 4 houses that have been consulted are tabulated. In this general way, new cases that were written up in April, for example, will come up for revision in July, and so on. Thus a revision system is continuously in operation in each city.

Ratings Divided into Two Heads.—Two items are covered in the rating: the capital, and the grade of credit, whether good, fair, or limited. The fixing of the capital rating is not, as a rule, a difficult matter for a mercantile agency, provided no unusual obstacles have been encountered in the investigation. It might seem, off-hand, that the rating could be based upon the net worth as shown in the statement, but this is not always

true, as there is frequently a material difference between such "book worth" and the worth for credit purposes, which must of necessity represent the security available for the satisfaction of claims.

In analyzing statements, it will be found as a rule that assets tend to shrink, whereas liabilities show a tendency to increase. This results in a decrease of capital responsibility. Needless to say, important features of the current statements are closely compared with those of statements previously submitted. Later in the discussion more will be said about the comparison of statements as a means of judging credit.

Things Considered in Making a Rating.—In his investigation and in preparing to assign a proper capital rating for credit purposes, a reporter is obliged to consider not only the amount but the character of the principal assets. For instance, merchandise requires a consideration of its character, whether staple or specialized and seasonable, whether well-selected, bought properly, conservatively inventoried, adequately insured, and in good, clean, salable condition.

Accounts Receivable.—As a rule, accounts receivable must be regarded as subject to shrinkage in arriving at a credit worth. If assigned as security for loans or other indebtedness, they must be eliminated entirely from the list of available assets. While it is not obligatory, a favorable impression is always created, both from a mercantile and a banking angle, when it is found that accounts receivable are protected by an adequate amount of credit insurance. Some banks now have a line upon their statement forms asking if accounts are protected in this manner.

The growing practice of carrying insurance upon the lives of executives, payable to the business, also tends to promote a feeling of confidence in the stability of the enterprise should those executives be suddenly removed.

Working Capital.—Another factor taken into consideration in making credit ratings by agencies pertains to working capital. It is always important to ascertain whether or not a company has available a proper amount of capital for the conduct of its business. The most modern plant is of no particular service in taking advantage of available business if funds cannot be obtained for the turning of the wheels. A concern may be doing an active business of much larger volume than warranted by its ready capital which, of course, must receive consideration in the assigning of a credit rating. It is frequently found that so much capital is being withdrawn from the business for investment in real estate or other ventures, as to actually handicap the merchant in paying his bills. Should the real estate be held in joint title, it must be disregarded in estimating the credit worth. These outside ventures sometimes necessitate endorsements or the assuming of other contingent liabilities in such amount as seriously to impair the available responsibility.

The Type of Business and Mercantile Ratings.—The subject's business is also considered, whether new or well-established; of steady volume or seasonable; if of a staple character or speculative; if profitable, or under excessive expense. The annual sales and amount of merchandise will afford some idea of the earning power and turnover. It is also important to know whether or not the subject has the reputation of getting fair prices. The price-cutter is bad for business, and even though he eventually fails, he in the meantime exercises a demoralizing influence.

With corporations it is sometimes important to consider whether those interested are concerned chiefly in making money from business operations or from stock-jobbing and manipulation. It is also well to bear in mind that their personal resources cannot be reached for corporation debts, unless made available through endorsement or individual guarantee. Stockholders, loaning money, must be regarded as creditors of the

corporation and are very often in a position to protect their claims even at the expense of outside creditors.

Market Conditions and How They Affect Ratings.—Market conditions may also have a direct bearing. If the subject is known to be loaded with abnormally high-priced merchandise, a sudden slump may occasion a decided change in his worth. With manufacturing enterprises, it is necessary to consider the advantages or disadvantages of their location for obtaining raw material and labor, for marketing their product, and for many other matters relating to operation.

Liabilities.—Examination of liabilities requires consideration of how much is owing on open account and in notes; whether scattered or held by a few concerns able to carry the subject in case of emergency; whether they are excessive in proportion to quick assets; whether this is a usual condition or seasonable; and whether any indebtedness is secured, and how.

Establishing the Proper Credit Grade.—Commercial agencies are not so much concerned with the risk of the secured creditor as with preserving the interest of the general creditor. After fixing the capital rating, they next establish the proper credit grade. And here they often find themselves in difficulty.

First of all, it must not be assumed that because a merchant is prompt in payment he is, for that reason alone, entitled to a first-grade credit rating. Credit is influenced, as we have already seen, by a number of considerations—not only the matter of payment, but the antecedents, general reputation, habits, business ability and methods of the applicant, and the general condition and nature of his business; the proportion of liabilities to quick assets and general financial condition. Indeed, the fixing of a proper credit grade is as complex a proceeding for the mercantile agency as determining a line of credit is for the banker. Thus, like the banker, the mercantile agency considers

some of the following in establishing the correct rating for a concern.

Is the location of the business good? How are general trade conditions affecting the business? Poor location, poor health of business, general trade conditions, may render prospects doubtful and cause a shading of credit grade, even though payments are for the time being prompt. This may serve to explain why customers with whom one has always had satisfactory experiences in the matter of payments are sometimes not quoted with a first-grade credit.

Rating Corporations.—In rating corporations the procedure is practically the same as for firms, except that the names of officers and directors must be obtained together with the amount of authorized capital, the amount of common and preferred stock, as well as the rate and character of dividends upon the latter; how much of each class of stock has been issued and paid in, how much in cash, merchandise, real estate or other tangible assets, and how much for goodwill, patents, formulae, services, and other assets of an intangible nature.

Mercantile agencies do not rate upon stock subscriptions, preferring to wait until the transaction has actually been consummated and the money placed at the risk of the business. Only tangible assets can be considered in arriving at an estimate of the credit worth; not that they have no intangible value, but that the credit man is obliged to look to the ultimate security. Patents, patterns, formulae, and the like, may be among the most valuable assets possessed by a going concern, but the mercantile credit man, and the banker as well, would find it difficult to estimate the amount which might be realized upon them in liquidation for the satisfaction of his claim.

Reluctance of Agencies to Rate above Paid-In Capital.—A corporation's net worth, as shown by its books, is the amount of its paid-in capital plus its surplus. Since surplus is really

a liability owing to stockholders, care is sometimes necessary in rating upon it, unless the officers declare in writing that it is to remain at the risk of the business. For instance, suppose the corporation's surplus contains a large amount of cash or accounts receivable which might be quickly converted into cash. The directors, in that event, could legally withdraw any or all of it in dividends, so that commercial agencies hesitate to rate in excess of paid-in capital, unless the surplus is quite largely represented in assets so closely identified with the business as not to be readily removed without occasioning comment. Of course, judgment must be exercised as to whether the amount of cash and accounts receivable is excessive in proportion to volume and needs of the business, and whether it could be readily removed without causing stringency.

Special Trade Credit Agencies.—One of the most helpful sources of credit information, particularly in large commercial centers, is that furnished by the special trade credit associations or agencies. In many lines of activity, there are clearing centers wherein information concerning a particular line of business is exchanged. They are often of much value to the banker when other sources have failed to supply the required information.

Keeping up with the Borrower Through Clipping Bureaus.—In almost every well-managed institution there is a department of the credit end of the bank devoted to accumulating useful credit data. Individuals are assigned to make clippings concerning the progress and change of activities of depositors and borrowers, and also of those companies which may be helpful to the customers of the bank by way of general information. Many large banks are so well organized that they can give one almost a complete history of a corporation's progress through the clippings made from the newspapers and magazines.

From the point of view of the borrower, it is worthwhile to remark here that a constructive policy on the part of every borrower would be to mail a clipping of any data pertaining to the activities of the company appearing in the newspapers or other periodicals which might be of interest to the banker and aid him in his efforts to keep his files up-to-date regarding his depositors and borrowers. Often when considering a loan regarding a well-known company the banker will consult this clipping bureau, and will find some helpful data filling out the antecedents of the subject, and giving a good idea of the progress made during the past few years as discussed by the press.

The need for co-operating with the banker in securing adequate trade references, and realization of the importance of external investigation in deciding the merits of commercial loans, have been touched upon in some detail so that the borrower may appreciate the care taken in establishing the basis for his credit.

Business today is becoming so complex, owing to the great combines and the increasing magnitude of credit operations, that more and more scientific methods are needed on the part of banks and merchants to safeguard their commitments. Because this is true, the applicant for commercial banking credit should do all he can to lighten the burdens cast upon the credit department by submitting his data freely, realizing at the same time that confidence is built up by complete knowledge, and that truth can be established in credit matters only after the banker has in his possession all the facts upon which to make a decision.

The borrower would do well, when making application for credit from a bank, to put himself in the place of the banker. When one stops to consider that Bradstreet's shows that there were 411,348 business failures in the United States during the past 35 years, he pauses to reflect.

A few years ago there were no credit associations and few

credit departments in banks or mercantile houses. Today banks, trust companies, and merchants are progressing rapidly toward a scientific system of credit analysis, and with the aid of national credit associations, mercantile agencies, special agencies, and its own comprehensive organizations for assimilating credit data, business should move safely forward, confident in the future of credit based upon truth.

CHAPTER VI

COMMERCIAL BORROWER'S FINANCIAL STATEMENT

Importance of a Well-Balanced Financial Structure.—In Chapter II the importance of the use of financial statements was stressed. It is now appropriate to set forth the advantages of a well-balanced financial structure, so that the commercial borrower may meet competitive conditions, not only in buying and selling prices, but in efficiency and economy in the use of his capital, and so that he may be able to present a statement worthy of the banker's acceptance when applying for a loan. The following eight chapters have for their main purpose to show the borrower how to set forth the financial condition of his business in his financial statement in whatever form presented, so that when submitted to a banker he will be able to judge whether or not the statement is a true and frank presentation of the facts.

It is the experience of bankers that every business man must not only know how to read the financial statement of his own concern, but as a credit seeker, investor, or whatever his interest may be, he must be able to analyze the statements of other firms as well. In undertaking to do this the borrower, even though limited in his preliminary training as a student of finance, will find there is no great mystery surrounding this subject, but that by clearly understanding the basic underlying principles, he will be able to get an accurate picture of a financial situation.

Every type of business has a financial set-up peculiar to that particular business. For every enterprise there are competitive standards to be met in turnovers and in unit fixed

expenses and financial burdens, which only a careful study of the financial statement will reveal. Therefore, to get the most out of any business, and the most consideration from any bank in the matter of accommodations, the applicant must be alive to the character of his investment in the enterprise. The relative amount of capital tied up in each class of assets, and whether such a financial structure is best adapted to the particular business concerned, is an all-important consideration if a good statement showing is to be made. The satisfactory adjustment of the funds invested in a business enables it to maintain the most advantageous unit fixed costs, and the most favorable turnover, and consequently a strong financial position resulting from substantial profits.

It is essential, then, that the financial structure be specially appropriate to the particular business. If it is not, the fact is evidenced by statement analysis, as shall be seen later, in some unfavorable turnover or financial relationship, which, if not heeded by the borrower, may eventually limit credit accommodations at the bank. Thus, too large a proportion of the total capital invested in fixed properties will be reflected in an unfavorable turnover on the fixed property investment. When there is an excessive inventory investment, it will be indicated by a subnormal turnover of inventories. Larger accounts receivable from customers than warranted by the volume of business done and the terms of sale will be indicated by an unfavorable turnover of accounts receivable.

For the commercial borrower who studies his own balance sheet carefully these things will indicate a financial structure unsuitable for the kind of business done, and will often entail burdensome expenses and financial responsibilities which will not only reduce the amount of total profits on the investment, but may eventually result in such financial weakness as to make it impossible for a bank to extend credit. For this reason the successful credit applicant is ever watchful of his financial condition as revealed by his balance sheet position, and is ever

ready to adopt a policy making for sounder and more conservative conduct of business.

The Financial Statement.—In the previous chapters attention was directed to the use of financial statements and to some of the advantages which their use brings to the borrower when presented to the banker. An attempt was made to show how the merchant's most valuable possession, aside from his assets, is a good reputation as a credit risk. Under present methods of conducting business, the best way for him to prove his title to credit is to submit a statement of his financial condition, so that the character of his financial structure may be readily and clearly discerned by the loaning banker.

Lack of Uniformity in Statements.—When one stops to consider that until recently the average commercial borrower, outside of the large metropolitan cities and a few other financial centers, did not even give his banker a full balance sheet, it is not surprising to note that there is a great lack of uniformity in financial statements. Yet the Federal Reserve Banks and the Federal Trade Commission have been encouraging the use of complete statements, and urging the standardization of statement forms wherever possible. The Federal Income Tax Law has also influenced the use of statements, and has done much to encourage more accurate accounting and the compilation of useful financial data. Not only has an effort been made to make a clearer and more systematic balance sheet, but to develop an understandable profit and loss statement as well.

Because of the significance of the comparative figures taken from the applicant's balance sheet in determining what line of credit a bank is willing to extend, it will be appropriate here to present a typical statement form. The balance sheet shown in Figure 1 reveals in a general way the type of financial information required by banks in passing on a loan. This particular statement is sent out by one of the Federal Reserve Banks to

To the _____ Bank

of _____

Name _____

Location _____ Branches _____

Business _____

For the purpose of procuring credit from time to time, the undersigned hereby makes to you the following statement of the condition of the undersigned on the _____ day _____ 19____; and the undersigned hereby maintains and guarantees that said statement is in all respects true and correct; and you may consider said statement as to the pecuniary responsibility of the undersigned as continuing to be true and correct until written notice of a change is given to you by the undersigned.

Fill all blanks, writing "no" or "none" where necessary to complete information.

ASSETS	Dollars	Cts.	LIABILITIES	Dollars	Cts.
Cash on Hand and in Banks			Bills Payable for Merchandise		
Accts. Rec. from Customers, not pledged			Bills Payable to Banks		
Bills Receivable, from Customers, not pledged			Bills Payable for paper sold		
Acceptances of Customers, not pledged			Accounts Payable for Merchandise		
*Merchandise, Finished			Trade Acceptances Given		
" Unfinished			Notes and Accounts Payable to Officers		
" Raw Material			Money Deposited with this Company		
U. S. Securities			Tax Payment Reserve		
Listed Stocks and other Bonds			Bonds or Mtges. Maturing within 12 months		
			Accrued Interest, Rent, Labor, Salaries, etc.		
TOTAL UNPLEDGED CURRENT ASSETS			DIRECT CURRENT DEBT		
Accts. Receivable from Customers, Hypothecated			Liability on Accts. Receivable Pledged or Hypothecated		
Notes Receivable from Customers, Hypothecated			Liability on Notes Receivable Pledged or Hypothecated		
Acceptances of Customers Discounted			Liability on Acceptances Pledged		
Merchandise, Pledged or Hypothecated			Notes or Accounts secured by Merchandise		
Securities " " "					
TOTAL CURRENT ASSETS			TOTAL CURRENT DEBT		
Notes and Accounts Received from Officers, Directors, Stockholders or Employees			Bonds Maturing after 12 months		
Due from Affiliated or Subsidiary concerns for Merchandise			Mtges. " " 12 "		
Otherwise due from Affiliated or Subsidiary Concerns			Chattel Mortgages		
Stocks and Bonds, Affiliated or Subsidiary Concerns			TOTAL DEBT		
Stocks and Bonds other than Affiliated or Subsidiary Concerns, not listed			Reserve for Depreciation		
Real Estate (land)			" " "		
Buildings			" " "		
Machinery, Fixtures and Equipment			Capital, Pfd.		
Supplies			Capital, Com.		
Ins., Rent, etc.			Stock, No Par		
Good Will, Patents, Trade Marks, etc.			Surplus		
Other Deferred Charges			Undiv. Profits		
Other Assets (of what composed)					
TOTAL			TOTAL		

*Unless otherwise specifically noted all Merchandise has been figured at cost or market, whichever is lower.

Figure 1a. Form sent out by a Federal Reserve Bank

Dr. PROFIT AND LOSS ACCOUNT, FISCAL YEAR ENDING _____ 19__ Cr.

Actual expense of conducting business	$	GROSS PROFITS	
Bad Debts charged off	$	From Merchandise	$
Charged off for depreciation	$	From Interest and Discounts	$
Dividends Paid	$	From Investments	$
Net Profits	$	From Other Sources	$
TOTAL	$	TOTAL	$
Notes or Accounts Receivable discounted or sold	$	Net Sales during year	$
Accommodation Endorsements	$	Insurance carried on Merchandise	$
Other Contingent Liabilities	$	Insurance carried on Buildings and Equipment	$

RECONCILEMENT OF SURPLUS

Undivided surplus at Close of Previous Year	$		
Less Change Not Applicable to Current Year	$	$	
Add Net Profits as Above		$	$
Less Dividends (Preferred ___%)		$	
" " (Common ___%)		$	$
Present Undivided Surplus			$

CONTINGENT LIABILITY

Is statement audited by a Certified Public Accountant? If so, by whom? _____

Have you any Contingent Liabilities for:
- Accommodation paper or endorsements for others _____ $ _____
- Foreign Credits including discounted drafts _____ $ _____
- Guarantee of Dividends or accounts of subsidiaries _____ $ _____
- Litigation on or threatened _____ $ _____
- Guarantee of stocks, bonds or mortgages _____ $ _____

Are all bad and doubtful assets excluded from above statement? _____

Does your deferred indebtedness constitute a lien on current assets? _____

GENERAL INFORMATION

In whose name does your real estate stand of record? _____

Are any of your officers insured for benefit of Corporation? If so, give Amount _____

Fire Insurance on Buildings and Plant $ _____ On Merchandise $ _____ Total $ _____

Other Insurance _____

Give basis of statement, whether actual inventory, by whom taken and date, or if estimate, by whom made and date _____

Time and amount of your Maximum Indebtedness during the past year _____ Month _____ $ _____

Time and amount of your Minimum Indebtedness during the past year _____ Month _____ $ _____

*Are any of your officers connected in any way with other enterprises and do they endorse for others? If so, please give particulars: _____

Give the names of all Banks where accounts are kept, lines of credit given by each, and method of borrowing (against collateral endorsements or other security):

		Method:
	$ _____	
	$ _____	
	$ _____	
	$ _____	
	$ _____	

Do you ever borrow on collateral? _____

Other Banks, Bankers and Brokers handling notes and other sources of credit: _____

State whether the proceeds of loans applied for are to be used:

(a) For permanent investments, that is, investments in lands, plants, machinery, improvements, or transactions of a similar nature? _____

or

(b) For agricultural, industrial or commercial purposes, in connection with the production and distribution of commodities? _____

Do your plans for the current year involve any material additions or improvements to your real estate, plant or equipment? _____

If so, please state the nature, approximate cost and method of financing such changes _____

Figure 1b. (Continued)

DUE FROM CONTROLLED OR ALLIED CONCERNS

Name of Concern	Location	For Advances	Terms	For Merchandise	Terms
		$			

RECEIVABLES DUE FROM OFFICERS, STOCKHOLDERS OR EMPLOYEES.

Name	Position	Amount	Since when	Due	Secured?	How?	Why Extended

STOCKS, BONDS AND INVESTMENTS

Give description and cash market value:

OFFICERS

	Name in Full	Number of Shares Held	Address
President			
Vice President			
Secretary			
Treasurer			

DIRECTORS

Name in Full	Number of Shares Held	Address

In what state incorporated_____ Date of incorporation_____ Capital Stock authorized $_____

The foregoing statements and details pertaining thereto, both printed and written, have been carefully read by the undersigned, and I hereby solemnly declare and certify that the same is a full and correct exhibit of our financial condition.

Corporation Name_____

By_____

Date Signed 19 (Officer's title must be given)

Figure 1c. (Continued)

FORM No. 3—FARMER

FINANCIAL STATEMENT

Form Approved by the Illinois Bankers Association

Statement of.....Address....., Ill., R. R. No.....

(BANK NAME IMPRINTED HERE)

For the purpose of procuring and maintaining credit from time to time in any form whatsoever with the above named bank, for claims and demands against the undersigned, the undersigned submits the following as being a true and accurate statement of the financial condition of the undersigned on the following date, and agree that if any change occurs that materially reduces the means or ability of the undersigned to pay all such claims or demands, the undersigned will immediately and without delay notify the Bank; and unless the Bank is so notified, it may continue to rely upon the statement herein as a true and accurate statement of the financial condition of the undersigned on this date, and in case of failure to so notify the Bank, or if this statement is false in any material respect, the Bank may declare due and payable all obligations of the undersigned to the Bank.

ASSETS			LIABILITIES		
Cash on hand and in bank			I owe notes to the following banks:		
Loans due me, secured			.....Bank		
Loans due me, unsecured			.....Bank		
Accounts due me			.....Bank		
Cash value of insurance policies			Notes payable to relatives and friends		
Stocks and bonds			Notes payable to others		
United States securities			Accounts and bills due others		
Live stock (see schedule)			Premiums on life insurance		
Grain and farm products (see schedule)			Interest and taxes due		
Other quick assets			Cash rent		
Total Quick Assets			Total Current Liabilities		
Farm land (see schedule)			Real estate mortgages		
City and town property (see schedule)			Chattel mortgages		
Farm implements and tools			Judgment and other liens		
Machinery, viz., threshers, balers, tractors			Grain products reserved for feeding stock		
Automobiles and trucks					
			Total Current and Deferred Liabilities		
			Net Worth		
Totals			Totals		

SCHEDULE OF REAL ESTATE

Title in the name of	Description of Property	Acres	Sec. Lot	Twp. Block	Range Div.	Present Value	Amount of Incumbrance	Mortgage Due
					Total - - - - -			

LIVE STOCK			GRAIN AND FARM PRODUCTS		
			Growing Crop	On Hand	
.....horses.....mules.....colts @.....			.....acres corn	.....bus. corn @.....	
.....milk cows.....calves.....heifers @.....			.....acres wheat	.....bus. wheat @.....	
.....beef cattle.....feeders.....stockers @.....			.....acres oats	.....bus. oats @.....	
.....brood sows.....pigs.....stock hogs @.....			.....acres meadow	.....tons hay @.....	
.....sheep.....ewes.....lambs - @.....			.....acres clover	.....tons clover @.....	
Totals - - - - - - - - - - - - - -			Totals - - - - - - - - - - - - - -		

CONTINGENT LIABILITIES		
As endorser or guarantor on notes of others - - -		
As mortgagor of real estate sold - - - - - -		
As security or bondsman for other persons - - -		
On leases or contracts - - - - - - - - - - -		
For judgments or suits pending against me - - -		
Totals - - - - - - - - - - - - - -		

LIFE INSURANCE

Name of Company	Beneficiary	Amount	Cash Value
Totals - - - - - -		$.....	$.....

Figure 2a. Statement Form Approved for use of Farmers by the Illinois Bankers' Association

GENERAL INFORMATION

Assets Pledged or Hypothecated as collateral - - - $.....	References:.....
Insurance carried on buildings - - - - - - - - - $.....	Are you a partner in any firm?.....
Insurance carried on Live Stock - - - - - - - - $.....	Have you a special or limited partner?.....
Insurance carried on Machinery, Implements - - - $.....	Wife's name.....
Taxes for the year 192..... - - - - - - - - - $.....	I offer for collateral security, viz.:.....
General expenses for the previous year - - - - - - $.....	As endorser on my notes.....
Profits for the previous year - - - - - - - - - $.....	I rent.....acres from.....
Profits for the year before last - - - - - - - - $.....	My Farm Lease terminates March 1, 192.....

I have carefully read the contents of the above statement and certify that the same is a true statement of the facts as to my financial condition.

.....

Dated..... ....., 192.. .....

.....

Figure 2d. (Reverse of Figure 2a)

member banks desiring a pattern for the balance sheet form to be used by its own clients. It will be noticed that it is a detailed questionnaire, and covers thoroughly and in all particulars many of the essential facts to be considered in establishing the basis for accommodations.

But every business has its own peculiar financial structure. Because of this, when a bank presents its balance sheet form to the borrower and asks him to fill it out, oftentimes it is found that the items listed are not suitable for the particular type of enterprise. For example, one bank having a large number of lumbering companies on its books, has listed among the fixed assets, timber lands. For the shoe merchant this item would not be applicable. For a large leather company the items appearing on the statement would be still different. For this reason, bankers can only present a general form which can be adhered to as closely as possible in the interests of clearness and conciseness. The important thing is to give complete information, and if the items do not appear, they should be entered in the balance sheet form in their logical place so that the loaning banker will be able to get a true conception of the financial situation.

Special Statements.—Appreciating the difficulties incident to these diversified business activities, the Illinois Bankers' Association has adopted the form shown in Figure 2, which they recommend for country banks dealing with farmers. Different kinds of livestock and assets in the form of grain and farm products are listed so that the credit man and the borrower may get closer together in analyzing financial data in the interests of better credit commitments.

Some Requisites of the Ideal Balance Sheet.—In Chapter II it was pointed out how the manner in which a statement is made gives the banker an insight into the borrower's business methods and practices. The following are the requisites of an

ideal balance sheet, which, if adhered to by the commercial borrower, will be a guide to order and arrangement in presentation:

1. The assets should be properly valued and grouped and arranged in order of availability.
2. The liabilities should also be properly grouped and arranged in the order in which they will, or should, be discharged.
3. If possible, excess of assets or liabilities should be shown next, so that net worth or capital may be apparent.
4. A statement should be made showing to whom the excess belongs or from whom it is due.

It is highly desirable that there be more uniformity in the methods used in the preparation of balance sheet statements. Banks and bankers have a vital interest in the subject, because they are constantly passing upon credits based upon statements made by manufacturers and merchants.

Steps Toward Uniform Statements.—At the present time the Federal Reserve Banks are interested in a movement toward uniformity of financial statements. The question is of importance, especially to the Federal Reserve Banks, which might be asked to rediscount commercial paper based upon borrowers' statements. Through the courtesy of the Federal Trade Commission the Federal Reserve Board has been able to take advantage of a large amount of information and data which the Trade Commission acquired over a long period in connection with the study of the statements made by merchants and manufacturers, as showing the condition of their business. The suggestions which developed as a result of the investigation are set forth in a tentative proposal submitted by the Federal Reserve Board to improve methods for the preparation of balance sheet statements, as follows:

1. The improvement in standardization of the forms of statements.

2. The adoption of methods which will insure greater care in compiling the statements and the proper verification thereof.[1]

While previous reference has been made to the diversity of the financial structure of each type of business, much has nevertheless been accomplished to improve the value of the statements rendered and in securing statements which do not depend for their accuracy on a borrower's statement alone but are verified by independent scrutiny and audit.

Steps Toward Uniform Verification.—The superior value of a statement certified by trustworthy public accountants, as compared with an unverified statement, is generally conceded. At the present time, however, there is no uniformity as to the extent of the verification in the case of statements put forward as already verified. The Federal Trade Commission in the course of its investigation of business conditions also has been strongly impressed with the lack of uniformity, and has enlisted the aid of the American Institute of Accountants with a view to remedying the conditions. It is found that verified statements may be divided broadly into two classes:

1. Those in which the certificate is based on an examination of the books without personal supervision of inventories and independent appraisal of all assets with the aid of technical appraisers.
2. Statements verified with the personal supervision of inventories and independent appraisal of all assets.

The value of the two classes of audits, their relation to each other, depends to a great extent upon the character and magnitude of the business involved.

In some cases it is contended that method (2) has advantages over method (1). In other cases, notably those of large companies in which personal supervision of inventories is difficult and perhaps impracticable, and the value ascertained by an

[1] "Uniform Accounting," Federal Reserve Bulletin, April, 1917, p. 93.

independent appraisal of assets is liable to be considerably exaggerated, it is maintained the reverse may be true. That is to say, a verification based upon the books themselves without an appraisal may be, and, in some cases is, the safer method of procedure. It is highly desirable that the commercial borrower realize the value of the complete form of audit statement, although any plan for immediate adoption intended to produce practical results must recognize that under present practice probably more than 90% of the statements certified by public accountants are what are called balance sheet audits, such as are described in paragraph (1) above.

As a first step toward the standardization of balance sheet audits, and to insure greater care in compiling and verifying statements, the Federal Trade Commission requested the American Institute of Accountants to prepare a memorandum on balance sheet audits. This memorandum was duly prepared and approved by the council of the institute representing accounts in all sections of the country.

I have audited the accounts of Blank & Co. for the period from .....to.....and I certify that the above balance sheet and statement of profit and loss have been made in accordance with the plan suggested and advised by the Federal Reserve Board and in my opinion set forth the financial condition of the firm at.....and the results of its operations for the period.

(Signed) A. B. C.

Figure 3. Form of Certificate Recommended by Federal Reserve Board in Federal Reserve Bulletin, April, 1917

Figure 3 shows a form of certificate which is recommended by the Federal Reserve Board, if the auditor is satisfied that his audit has been complete, that it conforms to the general instructions of the Federal Reserve Board, that the balance sheet and profit and loss statement are correct, and that any minor qualifications are fully covered by the footnotes on the balance sheet.

Immediate and Ultimate Liquidity.—Having given some consideration to the form of the balance sheet, it is now proposed to take up the basis for the valuation of items on the balance sheet, with a view to discovering what light it throws on the borrower's capital and capacity.

In analyzing a borrower's statement the bank credit man has uppermost in his mind two questions:

1. Is there a reasonable certainty that the proposed loan will be met at maturity?
2. If unforeseen circumstances should prevent payment at maturity, will the loan be paid ultimately?

The answer to the first question is sought largely in the relation of the borrower's quick assets to his current liabilities. The answer to the second is sought in the relation of his slow or permanent assets to his permanent liabilities. Thus, to start off with, the banker divides both assets and liabilities into quick or current, and slow or permanent. A definition of these terms will follow. The current liabilities, under normal circumstances are paid out of quick assets. The permanent liabilities should be fully offset by slow or permanent assets.

Cash Realizable Value an Estimate Only.—Yet, in studying a financial statement, a credit man or borrower must realize that no concern is or can be liquidated and wound up with a resulting cash balance in hand exactly equalling the amount of the net worth shown in the balance sheet prepared prior thereto. For, with even the greatest amount of care and expert appraisement of assets, it is impossible to fix absolutely, in advance of an actual sale or an offer to buy, made by a responsible person in good faith, the cash value of such assets as merchandise, machinery or buildings. Until the exchange of such assets for cash has actually taken place, all calculations of realizable value are but expressions of opinion more or less accurate according to the ability of the appraiser and his knowl-

edge of market values; also according to his own experience in, or knowledge of, what has happened in other similar liquidations.

It is for this reason that great importance attaches to the valuations placed on assets, and that careful estimates be made of all assets in the financial statement. It can be seen that unless the estimates are approximately correct, being set forth on a proper valuation, neither very much too high nor too low, the business man and borrower may be deceived as to his real financial position.

Basis of Valuing Items on Balance Sheet.—Before defining the assets and liabilities appearing on the balance sheet and going forward with an analysis of statements, an effort will be made to examine the basis of valuation of items so that the borrower may obtain some idea of how full and fair values are determined, which at the same time are conservative.

The common basis for determining the value of balance sheet items is the going-concern basis; that is, the values assigned to the assets are the values of such assets to a going concern. The amount of the liabilities is determined and stated from the same point of view. Another basis for stating values on the balance sheet is the liquidation basis. By this method the values are stated on the assumption that the business is to be liquidated and the assets converted into cash and used in the payment of liabilities. A balance sheet prepared on this basis is termed a statement of affairs.

Because the banker is foresighted, and because he loans his funds with a view to possible ultimate liquidation in the case of some unforeseen circumstance, if a borrower's financial position seems to warrant it, the banker favors the liquidation basis for valuation.

In valuing items it is the experience of accountants generally that there is a tendency to anticipate profits, while it seems

to be a human weakness to understate losses. Too often the banker finds these tendencies reflected on the balance sheet by an improper statement of some of the items. For example, if depreciation is understated on the statement of income and expense, the relative fixed assets will be over-stated on the balance sheet.

Doubtless the borrower is interested in arriving at some definite basis for valuation which will be looked upon with favor by the loaning banker. It will be advisable, then, to consider some of the steps the applicant may take to test his method of making valuations. To state all the assets of a concern at a full and fair value, among other things, it is essential that:

1. Accounts receivable be shown at book value, less the estimated loss for bad debts. All debts proved bad should be at once eliminated from the accounts, and doubtful accounts should be set up under a separate heading.
2. The inventories should be stated at cost or market value, whichever is the lower. Special conditions under which other methods of valuation may be acceptable will be considered later. By market value is meant replacement cost, not selling price.
3. The prepaid expenses should be stated at cost and equitably allocated between periods.
4. The investments in other companies should be stated so as not to anticipate profits because of increases in market values, but so as to prepare for possible losses arising from this source. Bonds to be held until maturity must be stated at their proper amortized value if purchased at a discount or a premium.
5. The fixed tangible assets should be stated at cost less depreciation. Under special conditions appraisal values may be given recognition in the accounts.
6. The intangible fixed assets should be stated at cost less any sums properly written off.

The proper statement of values on a balance sheet which will satisfy the banker further requires:

1. That all determinable liabilities at their full amount be offset against the assets.
2. That proper mention be made of all contingent liabilities.
3. That the difference between the assets and liabilities be set forth so as to properly show the proprietorship claims and the value of each.

Need for Consistency in Stating Balance Sheet Valuations.—Often when a financial statement is presented covering two or more operating periods, the banker finds, upon analyzing them, that there is an inconsistency shown in the different valuations placed on the accounts appearing on the statement. Naturally, such a discrepancy arouses his suspicion, and at times he finds there is such a wide range between the items, that it is impossible for him to form an accurate judgment of the balance sheet position. This, of course, weakens the chance of accommodations being extended.

It is to be emphasized that the credit applicant presenting statistical data covering two or more operating periods be consistent in his valuations if they are to be of any use to the banker in judging them. Varying bases for valuing balance sheet accounts, and irregular practice in handling accounts from year to year, vitiate the value of both the balance sheet and the statement of income and expense as administrative reports, to the banker considering a line of credit. Illustrations of inconsistency in stating values are found in the following practices of some business firms.

1. Frequently provision for depreciation is increased in good years and decreased in bad. This is obviously incorrect, since depreciation is an operating expense, and no profit is earned until depreciation has been provided for.

2. Often repairs are decreased in the years when profits are poor. To do this causes the accumulation of deferred main-

tenance which increases the expenses of more prosperous years. This is obviously an incorrect and objectionable practice.

3. Sometimes smaller amounts are allowed for bad debts in years when profits are small. This means that heavier losses will fall on later periods when receivables are proved bad. If the falling off in profits is due to business depression, it is probable that the provision for bad debts should be increased rather than decreased, since other firms are apt to be suffering from the same depression and consequently may be unable to pay debts.

4. Too often inventories are valued differently, according to the business conditions. They should be valued at cost or market, whichever is lower, and at all times the anticipation of profit should be avoided and provision made for all possible losses.

5. Again, accrued liabilities may be omitted when it is desired to avoid an increase in the expenses for which they are incurred. The incorrectness of this is apparent.

6. In some instances deferred charges to expense may not be amortized on a consistent basis. This leads not only to a misstatement of financial condition, but also to an unfair distribution of the asset burden, and it is confusing to the banker.

7. Fixed assets are at times increased in value, and the increase is shown as an operating profit. Such increases (except under rare conditions) should not be entered in the accounts. When entered they should be clearly designated to show their nature.

While it is true that the Federal Income Tax Law, coupled with the regulations of the Internal Revenue Department, have done much to cause business firms to practice consistency in keeping their accounting records, there is yet much to be desired in this respect, and bankers are constantly encouraging their borrowers, for their own good, to observe consistent valuations.

One reason for the inconsistencies in the valuation of bal-

ance sheet items is the conflicting points of view from which the balance sheet may be considered. Although in a previous paragraph it was stated it is generally agreed upon among both accountants and business men that the commercial balance sheet be prepared as of a going concern, many, especially among bankers and credit men, unconsciously think in terms of liquidation when discussing balance sheet valuations.

Again, there is often a difference between the original cost, the replacement cost, and the income-producing value of an asset. A concern may have erected its plant 20 years ago when building was cheap. The original cost is far less than present-day replacement cost. The appraisal value, which is the depreciated replacement cost, may be quite different from the book value, which is the depreciated original cost. From the point of view of income, the latter is the appropriate value, but from the point of view of financial condition, arguments can be offered for the former. Similarly, deferred charges to profit and loss are often carried as "courtesy assets." They represent items which cannot be absorbed in current expense, and are, therefore, carried forward and must be shown as a balance sheet item. Take, for example, a street railway. It may be required by law to change its roadbed and equipment, and the book value of the equipment scrapped may be so large that it cannot be absorbed by reserves or surplus. Part of this loss will be carried forward to future periods.

It is very important that one who constructs a balance sheet should maintain a consistent point of view. If it is necessary to vary from this, the variation should be clearly shown on the face of the balance sheet.

Balance Sheet of the Individual.—In previous sections it has already been shown how a balance sheet is intended to show, with regard to any commercial unit, its assets, liabilities, and proprietorship, properly classified and properly measured. This unit of organization may be an individual, a partnership, cor-

To the **LAKE SHORE TRUST AND SAVINGS BANK** BALANCE SHEET OF INDIVIDUAL

Name .....

Business .....

Location .....

For the purpose of obtaining credit, from time to time, with the above bank for our negotiable paper, or otherwise, the undersigned furnishes the following statement of condition as of the ..... day of ....., 19..., and the undersigned hereby agrees and guarantees that said statement and all other information herein furnished is in all respects true and correct.

Fill all blanks writing "no" or "none" where necessary to complete information

ASSETS		LIABILITIES	
Cash on hand and in bank		Notes payable to own banks, secured	
Notes receivable of customers, good		Notes payable to own banks, unsecured	
Accounts receivable of customers, good		Notes payable for merchandise	
Trade or bank acceptances		Notes payable to others	
Merchandise, finished ... $		Trade or bank acceptances	
Merchandise, unfinished ... $		Open accounts, not due	
Raw material ... $		Open accounts, past due	
Consigned merchandise ... $		Deposits of money by relatives or employees	
Total merchandise ... $		Deposits of money by others	
Less reserves ... $		Income and excess profit taxes, due during fiscal year	
United States Securities		Accrued property taxes, interest, etc.	
Other stocks and bonds listed on Exchanges, market value		Mortgages or liens on real estate; due during fiscal year	
Other Quick Assets and of what composed:		Other current liabilities and of what composed:	
Total current assets		Total current liabilities	
Notes receivable of customers, doubtful			
Accounts receivable of customers, doubtful			
Unlisted Stocks, Bonds and other Investments		Mortgages or liens on real estate, due after fiscal year	
Real Estate		Chattel mortgage notes	
Machinery and fixtures		Other liabilities and of what composed:	
Autos, horses, wagons, etc.			
Other assets and of what composed:		Reserves	
		Total indebtedness	
		Net Worth	
Total assets		Total	

Condensed Profit and Loss Statement for Fiscal Year Ending ..... 19...

Expense		Income	
Cost of material or merchandise consumed (To inventory at beginning of the year, add all purchases made during the year, and from that total deduct inventory of current year.)		Net Sales	
		From Investments	
Actual expense of conducting business		From Interest and Discounts	
Bad debts charged off		From other sources	
Depreciation charged off			
Withdrawn—Salaries, etc.			
Net Profits			
Total		Total	

Reconcilement of Net Worth

NET WORTH AT CLOSE OF PREVIOUS FISCAL YEAR			$
ADD OR DEDUCT ITEMS NOT APPLICABLE TO CURRENT YEAR	$	$	$
NET PROFIT OR LOSS AS ABOVE		$	$
LESS—WITHDRAWALS (other than salaries as above)			$
NET WORTH (as shown above)			$

Figure 4a. Balance Sheet of Individual

REAL ESTATE

TITLE IN NAME OF	LOCATION	IMPROVEMENTS	VALUE	MORTGAGES	INSURANCE

STOCKS, BONDS AND INVESTMENTS

NAME	AMOUNT	WHERE LISTED	PAR VALUE	MARKET VALUE	VALUATION USED IN STATEMENT

Contingent Liabilities:

Upon rediscounted receivables .....

Upon accommodation endorsements .....

For guarantees .....

For surety or other bonds .....

Is there any other person interested in your business, either as special or limited partner? ..... Are you a partner in any firm? .....

Regular time of taking inventory ..... On what basis, cost or market prices? .....

Is statement based on actual or estimated inventory? ..... By whom made? ..... Date .....

At what time of year are liabilities the heaviest? ..... When the lightest? .....

Average terms of sales ..... Average terms of purchases .....

Fire insurance on merchandise, $ ..... On building, $ ..... On machinery and fixtures, $ .....

Life insurance, $ ..... Beneficiary ..... Name of Ins. Co. .....

Are there any judgments unsatisfied, or suits pending against you, and for what amount? .....

Name of mercantile houses from which principal purchases are made:

The foregoing statements and details pertaining thereto both printed and written, have been carefully read by the undersigned, and I hereby solemnly declare and certify that same is a full and correct exhibit of my financial condition.

(Sign here) .....

Date signed ..... 19..

NOTE:—If you have any difficulty in filling in the foregoing statements and questions, the Credit Department of this bank is prepared to extend you courteous and intelligent service; in fact, we solicit your co-operation and acquaintance with our credit methods.

Figure 4b. (Continued)

poration, an estate or trust, or any other unit recognized commercially. It is essential that mention be made of the classification here, inasmuch as requests from banks for unsecured commercial loans are frequently made by the different units, which are chiefly differentiated as follows.

A balance sheet may be prepared for any person displaying all his assets, all his liabilities, and his net worth. Or again, a balance sheet may be prepared for a certain activity only, as for instance, a balance sheet of a particular enterprise which may be only one of several enterprises owned by an individual. Such a balance sheet would show the assets, the liabilities, and the net worth of this enterprise, but would not include other assets or liabilities of the owner.

For example, John Jones may own a store. A balance sheet of this store would display all the assets associated with it, the liabilities that properly apply against it, and the resulting net worth. On the other hand, an entirely distinct balance sheet might be made for John Jones as an individual, displaying not only all the assets connected with his store, but all other assets which he may have. It would also display all his liabilities; and the resulting proprietorship would show his net worth as an individual. This might differ considerably from the net worth shown by the balance sheet of his store.

This condition frequently presents many problems to the borrower and his accountant. When preparing a balance sheet for a single industry owned by an individual, the determining of what assets to include is not so difficult. The problem lies in the liabilities. Presumably, only the liabilities attaching to this particular industry should be tabulated. Yet, since the proprietorship is not a legal entity, its integrity may be jeopardized by other liabilities of the proprietor. In such cases, the failure to display these liabilities would be reprehensible on the part of the borrower, who, by so doing, might easily lose the confidence of his banker.

(PARTNERSHIP OR FIRM)

TO THE _____ BANK

OF _____

NAME _____

LOCATION _____ BRANCHES _____

BUSINESS _____

FOR THE PURPOSE OF PROCURING CREDIT FROM TIME TO TIME, THE UNDERSIGNED HEREBY MAKES TO YOU THE FOLLOWING STATEMENT OF THE CONDITION OF THE UNDERSIGNED ON THE _____ DAY _____ 192__; AND THE UNDERSIGNED HEREBY MAINTAINS AND GUARANTEES THAT SAID STATEMENT IS IN ALL RESPECTS TRUE AND CORRECT; AND YOU MAY CONSIDER SAID STATEMENT AS TO THE PECUNIARY RESPONSIBILITY OF THE UNDERSIGNED AS CONTINUING TO BE TRUE AND CORRECT UNTIL WRITTEN NOTICE OF A CHANGE IS GIVEN TO YOU BY THE UNDERSIGNED.

FILL ALL BLANKS, WRITING "NO" OR "NONE" WHERE NECESSARY TO COMPLETE INFORMATION.

ASSETS		LIABILITIES	
CASH ON HAND AND IN BANK		BILLS PAYABLE, FOR MERCHANDISE	
BILLS RECEIVABLE, FROM CUSTOMERS, GOOD		BILLS PAYABLE, TO BANK OR BANKS	
ACCOUNTS RECEIVABLE, FROM CUSTOMERS, GOOD		BILLS PAYABLE, FOR PAPER SOLD	
BILLS AND ACCOUNTS RECEIVABLE, DUE FROM PARTNERS		BILLS PAYABLE, TO OTHERS	
BILLS AND ACCOUNTS RECEIVABLE, DUE FROM AFFILIATED OR ALLIED CO'S		BILLS AND ACCOUNTS PAYABLE, TO PARTNERS	
ACCOUNTS AND BILLS RECEIVABLE, DOUBTFUL		BILLS AND ACCOUNTS PAYABLE, TO AFFILIATED OR ALLIED CO'S	
MERCHANDISE, FINISHED		ACCEPTANCES	
MERCHANDISE, UNFINISHED		OPEN ACCOUNTS, NOT DUE	
RAW MATERIAL		OPEN ACCOUNTS, PAST DUE	
INVESTMENTS: BONDS AND STOCKS, "LISTED" (SEE PAGE 2)		LABOR, SALARIES, ETC.	
INVESTMENTS: BONDS AND STOCKS, "UNLISTED" (SEE PAGE 2)		DEPOSITS OF MONEY WITH US	
INVESTMENTS: BONDS, STOCKS, ETC. AFFILIATED OR ALLIED CO'S		MORTGAGE OR LIEN ON REAL ESTATE	
REAL ESTATE (MARKET VALUE)		WHEN DUE	
BUILDINGS		MORTGAGE OR LIEN ON PLANT OR EQUIPMENT	
MACHINERY AND FIXTURES		WHEN DUE	
INTEREST, INSURANCE, ETC.		CHATTEL MORTGAGE OR OTHER LIENS	
OTHER DEFERRED CHARGES		BONDED DEBT	
GOOD WILL AND PATENTS		WHEN DUE	
OTHER ASSETS AND OF WHAT COMPOSED		INTEREST, TAXES, ETC., DUE AND ACCRUED	
		OTHER LIABILITIES	
		TOTAL LIABILITIES	
		RESERVE FOR BAD DEBTS	
		RESERVE FOR DEPRECIATION	
		NET WORTH	
TOTAL		TOTAL	

DR. PROFIT AND LOSS ACCOUNT, FISCAL YEAR ENDING _____ 192__ CR.

ACTUAL EXPENSE OF CONDUCTING BUSINESS	$	GROSS PROFITS	
BAD DEBTS CHARGED OFF	$	FROM MERCHANDISE	$
WITHDRAWALS	$	FROM INVESTMENTS	$
NET PROFITS	$	FROM OTHER SOURCES	$
TOTAL	$	TOTAL	$
NOTES OR ACCOUNTS RECEIVABLE DISCOUNTED OR SOLD	$	NET SALES DURING YEAR	$
ACCOMMODATION ENDORSEMENTS	$	INSURANCE CARRIED ON MERCHANDISE	$
OTHER CONTINGENT LIABILITIES	$	INSURANCE CARRIED ON BUILDINGS AND EQUIPMENT	$

Figure 5a. Partnership Statement Form Approved by a State Bankers' Association

BILLS AND ACCOUNTS RECEIVABLE LISTED ON STATEMENT, ON WHICH YOU EXPECT TO REALIZE WITHIN 90 DAYS $_____

ALL LIABILITIES (EXCLUSIVE OF CONTINGENT) DUE AND PAYABLE WITHIN 90 DAYS. $_____

WHAT AMOUNT OF BILLS OR ACCOUNTS RECEIVABLE HAS BEEN ON THE BOOKS MORE THAN SIX MONTHS? $_____

WHAT AMOUNT OF BILLS OR ACCOUNTS RECEIVABLE IS PAST DUE, EXTENDED OR RENEWED? $_____

ESTIMATED REALIZABLE VALUE OF SLOW BILLS RECEIVABLE AND ACCOUNTS RECEIVABLE $_____

DOES THE ITEM BILLS AND ACCOUNTS RECEIVABLE FROM AFFILIATED OR ALLIED CO'S REPRESENT ACTUAL SALE OF GOODS?_____

WHAT PART REPRESENTS CASH ADVANCED? $_____

DOES THE ITEM BILLS AND ACCOUNTS PAYABLE TO AFFILIATED OR ALLIED CO'S REPRESENT ACTUAL PURCHASE OF GOODS?_____

WHAT PART REPRESENTS CASH ADVANCED? $_____

DO AFFILIATED OR ALLIED CO'S BORROW INDIVIDUALLY, OR ARE THEY FINANCED BY THE PARENT CORPORATION, OR BOTH?_____

IF ANY BILLS OR ACCOUNTS PAYABLE ARE SECURED BY COLLATERAL, ENDORSEMENT, GUARANTEE OR BOND, GIVE AMOUNTS AND HOW SECURED

WHAT WAS MAXIMUM AMOUNT SHORT-TERM LOANS DURING PAST YEAR, AND DATE? $_____

WHAT WAS MINIMUM AMOUNT SHORT-TERM LOANS DURING PAST YEAR, AND DATE? $_____

ANTICIPATED MAXIMUM AMOUNT SHORT-TERM LOANS DURING THE COMING YEAR? $_____

IS STATEMENT BASED ON ACTUAL INVENTORY?_____

HOW IS VALUATION ARRIVED AT,

(A) ON MERCHANDISE FINISHED?_____

(B) ON MERCHANDISE UNFINISHED?_____

(C) ON RAW MATERIAL?_____

IF COST PRICE EXCEEDS MARKET PRICE, WHAT PROVISION IS MADE FOR SHRINKAGE?_____

HAS ANY MERCHANDISE LISTED IN THIS STATEMENT BEEN ON YOUR HANDS OVER ONE YEAR? IF SO, AMOUNT $_____

IN WHAT MONTH IS INVENTORY HIGHEST?_____ IN WHAT MONTH IS INVENTORY LOWEST?_____

STOCKS, BONDS AND INVESTMENTS—GIVE DESCRIPTION AND CASH MARKET VALUE

_____ $_____ _____ $_____

_____ $_____ _____ $_____

_____ $_____ _____ $_____

_____ $_____ _____ $_____

OF REAL ESTATE IN NAME OF FIRM?_____

AMOUNT CHARGED TO DEPRECIATION ON BUILDINGS THIS YEAR, $_____ AVERAGE FOR PAST FIVE YEARS $_____

AMOUNT CHARGED TO DEPRECIATION ON MACHINERY THIS YEAR, $_____ AVERAGE FOR PAST FIVE YEARS $_____

WHAT PROVISIONS HAVE BEEN MADE FOR THE RETIREMENT OF BONDED OR MORTGAGE DEBT?_____

DO YOUR PLANS FOR YOUR FISCAL YEAR CONTEMPLATE ANYTHING IN THE WAY OF BUILDING OPERATIONS, PLANT EXTENSION OR INVESTMENT IN OTHER FIXED ASSETS?

IF SO, PLEASE STATE AMOUNT TO BE SO INVESTED? $_____

WHAT IS YOUR RELATIONSHIP WITH AFFILIATED OR ALLIED CO'S? PLEASE FURNISH FULL PARTICULARS_____

IF ANY OF THE ASSETS LISTED IN THIS STATEMENT ARE PLEDGED OR ASSIGNED IN ANY MANNER, PLEASE FURNISH FULL PARTICULARS_____

Figure 5b. (Continued)

NAMES DEPOSITARY BANKS, ALSO BANKS AND BROKERS HANDLING COMPANY'S NOTES, AND LINES OF CREDIT WITH EACH.

	$		$
	$		$
	$		$
	$		$
	$		$
	$		$

NAMES OF CONCERNS FROM WHICH GOODS, MERCHANDISE OR MATERIALS ARE PURCHASED.

PARTNERS

NAME IN FULL	NET OUTSIDE MEANS	PARTNERSHIP LIABILITY LIMITED TO	EXPIRATION OF PARTNERSHIP INTEREST	ADDRESS

I HEREBY CERTIFY THAT, TO THE BEST OF MY KNOWLEDGE AND BELIEF, THE FIGURES AND INFORMATION GIVEN ARE, IN EVERY RESPECT, TRUE AND IN ACCORDANCE WITH THE FACTS.

(SIGN FIRM NAME HERE)

DATE SIGNED _____ BY _____

Figure 5c. (Continued)

The accountant and the borrower he represents must keep in mind that if there is a possibility that any liability will become effective against the assets shown in the balance sheet, he must display this liability also. There does not seem to be any well-established rule covering this problem.

Balance Sheet of a Partnership.—Again, the organization for which a balance sheet is prepared with a view to applying to a bank for unsecured credit, may be a partnership. Figure 5 shows a partnership form recommended by a middle western state bankers' association. A partnership, because of the contractual relationship established between the partners, is recognized as having a commercial existence as somewhat

Form No. 2—CORPORATION

FORM APPROVED BY THE ILLINOIS BANKERS ASSOCIATION

CONFIDENTIAL

TO

(BANK NAME IMPRINTED HERE)

STATEMENT OF:
Corporate Name

Main Office

Branches

Business

Location of Plant

ASSETS		LIABILITIES	
Cash on hand and in Bank		Notes Payable for Merchandise	
Notes Receivable of Customers Current		Acceptances Issued	
Past Due, Cash Value		Notes Payable to Banks	
Accounts Receivable of Customers: Current		Notes Payable for Paper Sold	
Past Due, Less than 6 months		Notes Payable to Officers Directors and Stockholders	
Past Due, Over 6 months		Notes Payable to Others	
Acceptances of Customers		Accounts Payable—Not Due	
Merchandise: Finished		Accounts Payable—Past Due	
In Process, Unfinished		Accounts Payable to Officers Directors and Stockholders	
Raw Material		Accounts Payable to Officers Deposits of Money with this Co. by Officers and Others	
Collateral Pledged to Loans: Notes Receivable		Secured Liabilities by Notes Receivable	
Accounts Receivable		Accounts Receivable	
Trade Acceptances		Trade Acceptances	
Merchandise		Merchandise	
Securities		Securities	
Other Active Assets		Any Other Current Liabilities	
		Total Current Liabilities	
Total Active Assets		Mortgages or Liens on Real Estate	
Due from Controlled or Allied Concerns: For Merchandise		Bonded Debt	
For Advances		Chattel Mortgages	
Stocks, Bonds and Investments		Any Other Liabilities—Itemize	
Land			
Buildings			
Machinery, Equipment and Fixtures			
Horses, Wagons and Automobiles		Total Liabilities	
Notes Receivable—Due from Officers, Stockholders and Employees		Reserve—Itemize	
Accounts Receivable—Due from Officers, Stockholders and Employees			
Good Will, Patents and Trade Marks		Capital Stock—Pref. Outstanding	
Other Assets—Itemize		Capital Stock—Com. Outstanding	
		Capital Stock—No Par Value	
Deferred Assets		Surplus and Undivided Profits	
TOTAL		TOTAL	

Figure 6a. Corporation Statement Form Approved by the Illinois Bankers' Association

Contingent Liability of Any Kind

Upon Receivables Discounted or Pledged				
Upon Accommodation Paper or Endorsements				
Customers' Accounts Sold and Assigned				
As Guarantee for Others on Notes, Contracts, etc.				
For Bonds or Unfinished Contracts				
For Leases				
Other Contingent Liabilities				

Commitment Liability

Contract Price of Goods Purchased, Delivery to be made During 192				
Present Market Value of Goods Purchased, Delivery to be made During 192				

Insurance. Fire, on Buildings $ ..... Machinery, Fixtures and Equipment $ .....

Merchandise $ ..... Life in favor of Company $ .....

CONDENSED PROFIT AND LOSS STATEMENT FOR FISCAL YEAR ENDING 192

EXPENSE				INCOME			
Cost of Material or Merchandise Consumed							
Actual Expense of Conducting Business, Including Rent, Taxes, Insurance, etc.				Net Sales			
				From Investments			
				From Discount in Purchase			
Salaries Paid to Officers				From Other Sources—Itemize			
Int. on Borrowed Money, Bonds							
Bad Debts Charged Off							
Depreciation Charged Off							
Net Profits							
Total				TOTAL			

Surplus and Undivided Profits

At Close of Previous Year $														
Less Charges Not Applicable to Current Year	$													
Add Net Profits as Above—Itemize	$					$								
Less Dividends (Preferred (Per Cent)	$													
(Common (Per Cent)	$													
(No Par (Per Cent)	$					$								
Undivided Profits											$			

We hereby certify that the foregoing figures are taken from the books of this Company and that they and the Statements contained on both sides of this sheet are true and give a correct showing of the financial condition of the Company.

Signed this ..... day of ..... 192 .....

Name .....

By .....
(State official title)

I—We have audited the accounts of ..... for the period from ..... to ..... and certify that in my our opinion the above Balance Sheet and Statement of Profit and Loss set forth the financial condition of the firm or company at ..... and the results of its operations for the period.

.....
Public Accountants

WORTH OF ENDORSERS EXCLUSIVE OF THEIR INTERESTS IN THE BUSINESS

..... $ .... $ .....

..... $ .... $ .....

..... $ .... $ .....

Figure 6b. (Continued)

distinct from the proprietors as individuals. As a result, certain assets are recognized as assets of the partnership as distinct from those of any one of the partners. Similarly, there are liabilities of the partnership as distinct from the liabilities of the individuals composing the partnership. Because of this line of demarkation, a definite balance sheet can be established for a partnership, which must include all of the assets belonging to it and all the liabilities applying against it, the resultant net worth being that of the partnership without regard to the net worth of the individuals composing it.

Balance Sheet of a Corporation.—Perhaps the most significant commercial unit for which a balance sheet is prepared may be a legal unit known as a corporation (Figure 6); or it may be that the commercial unit really involves a number of corporations under the same or affiliated ownership. In the latter case, the consolidated balance sheet might be prepared to express the combined assets, the combined liabilities, with the resulting combined proprietorship, of the various corporations owned.

When application is made for credit under the circumstances last mentioned, it is essential that the borrower or borrowers show clearly the relationship between the different units, and so present the statement that the financial responsibility may be definitely located.

Other Commercial Units.—Lastly, other commercial units, such as joint-stock associations, trusts, syndicates, estates, etc., may be the bases of the balance sheet display for borrowing purposes. These are essentially no more than modifications of one or more of the three types of proprietorship just discussed. In preparing these statements for the banker, all the legal angles should be borne in mind, in order that the statements may be properly signed and presented by the responsible parties, and in order that they may have a clear financial meaning to the loaning banker.

CHAPTER VII

TERMS COMMONLY USED IN THE INTERPRETATION OF BALANCE SHEETS

It is desirable at this point to explain some of the balance sheet terms which have been occasionally used in previous chapters and which will constantly recur in the pages to follow. As it is not practicable to define and explain fully all the classifications which may appear upon a balance sheet, an effort will be made to select only those which are most common, and an understanding of which is necessary in the preparation and interpretation of correct balance sheets. Occasionally one finds in practice an unusual classification, such as should justify a special explanation in the balance sheet itself, as it probably pertains to some particular organization. It is not deemed advisable to include such items in this work or chapter. Also, there are certain classifications pertaining only to limited kinds of business, such as some of the classifications defined by the public service commissions of the various states, which it does not seem desirable to include here. Aside from such unusual accounts, this volume covers practically all the classifications appearing in the balance sheets of commercial organizations of standing, such as those whose securities are listed on the New York Stock Exchange.

Current Assets.—Current assets are sometimes known as liquid assets or floating assets. The group embraces cash and all assets held to be converted into cash. It includes merchandise held for sale, either in finished or unfinished form, together with such elements as raw materials and supplies which enter into it; and all other items resulting from its sale until finally realized in the form of cash.

The chief function of mercantile or manufacturing concerns is to convert commodities or services into sufficient cash to cover the cost and the expenses necessary for operations, and yield a profit to the proprietorship. This conversion may be direct, or the sale may be on open account, creating a balance sheet item called accounts receivable, or perhaps notes receivable. Such classifications are valueless to the organization save as they may be later converted into cash or its equivalent. Presumably all assets listed under the current classification move gradually toward a realized condition. During the period following the presentation of the balance sheet by the borrower, the merchandise will presumably be turned into receivables and the receivables be turned into cash. The length of time required for this process of conversion varies with the type of organization, the season of the year, and the relative efficiency of operation.

Sometimes current assets are defined by accountants as those which are most readily convertible into cash. This definition is inaccurate. Frequently real estate may be readily converted into cash, yet it belongs essentially in the group of permanent or fixed assets, for it is often not readily convertible into cash, requiring instead the constant effort of a large organization to effect conversion. In fact, the conversion of merchandise into cash constitutes the chief problem of many great organizations whose staff is maintained primarily to accomplish that purpose. The test usually applied by bankers in determining assets which may be classified as current is the availability of such capital in the near future for use in liquidating current liabilities.

In current assets should be included all those accounts representing the current or liquid investment of the business. Those which appear most often in balance sheets are:

Cash accounts
Accounts and notes receivable

Inventories
Prepaid expenses (current only) and accrued items
Marketable securities

Cash Value of Insurance.—Often, in banking parlance, the term "quick assets" is used as almost synonymous with current assets. It includes cash, receivables from others than officers, stockholders and employes, inventories and other items held for the purpose of converting into cash. When so used, the total of the above group appears as a subhead in the balance sheet, to which may be added securities held for sale or which are readily salable and the cash value of insurance. It excludes the receivables from officers, stockholders, and employes. The total then obtained is known as "current assets." This is the use recommended by the Federal Reserve Board in its bulletin of April, 1917. In practice the usage varies. But the term always indicates assets which in the ordinary course of operation will soon be converted into cash.

Cash Balances.—The item of cash balances is generally the first to catch the banker's eye when scanning the asset side of the balance sheet. It is the difference between the receipts from all sources on the one, or *debit* side of the cash book, and the payments on the other, or *credit* side of the cash book. The balance between the debits and credits is the exact amount by which the receipts have exceeded the payments, and cash should be found in the possession of the concern to an equal amount.

The items usually included under the heading of cash consist of one or more of the following:

1. Petty cash funds
2. Branch office funds
3. Miscellaneous funds in custody of officers or employes
4. Receipts not yet deposited
5. Bank balances

6. Funds in custody of other institutions or individuals
7. Cash in transit
8. Cash in foreign depositories

Accounts Receivable.—The term accounts receivable, when used without qualification in a balance sheet, means an aggregate amount due from trade debtors reduced by adequate reserves for bad and doubtful accounts, and excludes accounts which mature beyond the length of credit usually extended in the industry with which the concern is most closely identified. Other debts may be due which are legitimate current assets but which cannot truthfully be classified as good and due from trade debtors sold on the usual trade terms. The aggregate of such other items properly classified should be separately stated on the balance sheet so that no one will be deceived.

Notes Receivable.—Notes receivable may be due from customers for the sale of goods, when they are generally known as trade notes; or they may represent loans. They may also represent sales of plant or other property, but such notes are unusual and need not be considered as a class. A trade note may have been taken at the time of sale or may have been taken later in settlement of a past-due account.

In some lines of business, notably those where sales are made to farmers, such as the agricultural implement and fertilizer businesses, it is customary to grant long-term credit in the form of notes; but in most lines of business in this country, goods are sold on open account with short credit terms, or are covered by an accepted draft, so that trade notes are likely, as bankers find, to represent past-due accounts. For the purpose of properly stating the items in the balance sheet, the notes should be classified at least as between trade notes representing original transactions and those taken in settlement of open accounts. For the convenience of the commercial borrower a further classification of notes might be as follows:

1. Notes on hand
2. Notes out for collection (not overdue)
3. Notes in the hands of attorney or others (overdue)
4. Notes discounted (not due as yet)

Merchandise.—The word "merchandise" is used here in its broadest sense, as inclusive of all commodities which may be dealt in or used. The class of assets represented is somewhat loosely designated by business men, bankers, and accountants as inventories, but clarity of expression requires that the noun "inventory" be used only as denoting a list or record of quantities and values of merchandise determined to be on hand at a given time.

An inventory may also consist of wares out on consignment, but included in the company's merchandise inventory. Sometimes, in an effort to make a better statement, a company will consider merchandise shipped on consignment as a receivable and thus have the benefit of a sales price rather than a contract price in their assets. This is not correct and must be watched in dealing with companies selling on consignment.

The general classes into which merchandise falls may be stated as follows:

For manufacturing or producing concerns:

Finished goods, or finished product, or manufactured goods
Goods in process of manufacture, or partly finished goods or work in process
Materials or raw materials
Supplies or operating supplies

For mercantile concerns:

Trading stock, or merchandise
Supplies

For all other concerns, institutions, and organizations:

Supplies

Prepaid Expenses (Current Only) and Accrued Items.—Prepaid expenses include items such as prepaid insurance, rent, interest, etc., which have been expended for current operations and may have value in liquidation. It is preferable to make a distinction in the balance sheet between prepaid expenses incurred entirely for current operations, and long-term expenses which may be charged off entirely, when incurred, if conservative accounting practice is followed. Accrued items would include such assets as accrued interest, which are as good as notes receivable themselves. There may be included under the heading of prepaid expenses some or all of the following prepaid items:

1. Advertising
2. Insurance
3. Interest
4. Rent
5. Salaries and wages
6. Royalties
7. Taxes
8. Miscellaneous expenses

Marketable Securities.—It frequently happens that a firm, corporation or individual will have listed in the balance sheet marketable securities such as liberty bonds, or stocks or bonds listed on the exchanges. The banker will examine this heading to determine just what the market for the securities listed is and in whose name they are registered in case they are stocks, and ascertain their maturity if they are bonds. For this reason the borrower should be careful to give this information on the back of the balance sheet in detail, so that the values may be readily and conveniently checked.

Current Liabilities.—Leaving the current assets for a moment, the reader's attention is directed to the liability side of the balance sheet to consider the classification and definition

of current liabilities. Bankers are generally agreed that in the current liabilities should be grouped all those liabilities which are to be liquidated in the near future out of working capital funds. This will include such items as: Notes payable; accounts payable; accrued liabilities; federal taxes.

One of the principal criteria used by banks and accountants in determining whether or not liabilities should be classed as current is the time of maturity. A further point for consideration is whether or not such liabilities are to be liquidated out of current working capital funds. In case a long-term note issue or bond issue is maturing shortly and is not to be liquidated out of current working capital funds, but is to be replaced by other permanent long-term investments in the business, one would not be justified in classifying such an issue as a current liability, even though maturing in the near future.

At the same time, while long-term debentures and other forms of unsecured notes are considered deferred or slow liabilities, the banker does not lose sight of the fact that these have the same liquidating value in the event of trouble as his own loans. Bankers obviously like to see borrowers state the character of a liability and the date of maturity in the balance sheet.

Notes Payable.—The borrower, merchant or business man may find it convenient to classify notes payable as follows:

1. Banks or bankers
2. Trade creditors
3. Affiliated companies
4. Officers, employes

By so doing there will be no confusion in arriving at an appraisement, by the credit department, of the different kinds of notes for which a particular concern is obligated.

Accounts Payable.—A most important classification is that of accounts payable. All accounts payable should be

stated in the balance sheet, so that the amount due each class of creditors may be ascertained. However, where the amount due any class is relatively small, there is no objection to its being included with that for some other class. Accounts payable may be stated in the following detail, which will differentiate between the various types:

1. Trade creditors
2. Officers and employes
3. Affiliated companies
4. Deposits
5. Credit balances of accounts receivable

Great care should be exercised to make a proper distinction between merchandise contracted for and merchandise actually accepted. When merchandise has been accepted and the title to the goods has passed, the amount should be included in the inventory and the liability should be included in the payables. When the title has not passed, the item should be included neither in the inventory nor in the payables.

Accrued Liabilities.—Another group of liabilities which are often not as clearly designated in the balance sheet as they should be is that of accrued liabilities. Such liabilities may increase in amount from day to day without the occurrence of any new transactions. Past operations may have created certain liabilities which grow simply with the passing of time. For example, interest upon promissory notes accumulates merely as time passes. Commissions may accumulate as the result of sales or other primary transactions. At the date of a balance sheet, such accrued items should be accurately determined and displayed under suitable headings. It is not necessary to use a subtitle, under liabilities, specifically for such terms. Rather the accounts should be displayed under current liabilities, unless they are of a nature which does not permit of such classification. The names used should indicate the character of the

liability, as for example "accrued interest," or "interest payable," "accrued taxes," or "accrued payroll," so that there may be no question on the part of the credit man, banker or loaning officer as to just what the items represent.

Federal Taxes.—One of the items over which there has been much dispute between bankers, their depositors and the government is that of federal taxes. During the World War, at the time the excess profits tax law was in force, which provided a tax on amounts over and above specified figures, the exact amount of federal taxes was difficult to determine in advance of the actual preparation of the official returns and final settlement of the assessments with the government. During such times of emergency, returns had often to be filed long before the books of a business concern were closed. Even now, though the process of calculation is much easier, it is not always possible to ascertain the exact amount which will finally be paid as taxes for any one year. Thus it is that reserves are often set up annually to cover the unknown amount. In some instances the amount estimated for the year is placed in the financial statement as an accrued liability. Frequently a discussion arises between the tax payer and the Bureau of Internal Revenue, in which it appears possible, or even probable, that in addition to taxes already paid, further assessments on past years will have to be met. In such cases it is very difficult for a corporation to calculate the proper amount of reserve to be shown in its balance sheet. Not only that, but in contested cases, some proprietors and officials hesitate to set up the definite amount claimed by the government, fearing that it may be construed as an admission of their tax liability.

On the other hand, it is contended by some that those responsible for the financial affairs of a corporation do not wish to be put in the position of showing a surplus which may afterwards shrink considerably. To guard against any misap-

prehension the surplus shown in a balance sheet of the Consolidated Cento Fabrics Company is qualified as follows:

Surplus $9,865.76
(Subject to unsettled Federal Income Tax, the amount of which is not known)

Such a set-up meets with the banker's requirements, and is a sensible way of providing for the liability when it falls due.

Working Capital and the Financial Statement.—The longer a banker studies financial statements, and the wider his experience becomes in analyzing the different companies in different industries, the better he understands the different working capital requirements. No conservative banker can deal intelligently with the finances of particular concerns without becoming somewhat familiar with the working capital needs of that type of industry. Many are the prospective borrowers who come into banks with financial statements for the banker's consideration, wholly ignorant of the particular working capital needs of their special undertaking.

Because the banker, through his experience and the knowledge gained through statistical data, sees the importance of capital to successful operation, and how the lack of it causes failure,[1] he is ever watchful of the proportion of working capital in any statement presented to him as a basis for accommodation.

Working capital denotes free quick assets, or the difference between current assets and current liabilities; and without an adequate amount of cash capital invested in an enterprise, it could not be expected that there would be sufficient working capital. Lack of ample working capital often proves a great hindrance to operations, and at times prevents profitable development. A favorable ratio of current assets to cur-

[1] From data prepared from Dun's Review for the year 1926, it was found that there were 21,773 commercial failures, and of this number more than 25% were due to lack of capital.

rent liabilities is essential to a good credit position and to favorable consideration on the part of the loaning banker.

While companies are commonly expected by their banks to maintain a ratio of 2 to 4 dollars of current assets per dollar of current liabilities, it appears from statistics that industries cannot be said to have definite characteristics in this respect. Investigation reveals that in most industries there are companies having a high ratio and others having a low ratio. While investigation shows wide variations as between industries, the ratios of the companies within groups vary so widely that the averages for the different groups cannot be considered as characteristic of these industries. Therefore, no thinking banker can fairly look upon the two for one ratio alone as a criterion for judging financial strength.

The average ratio shown for 241 companies in the years 1916 to 1921 was $3.02 of current assets per dollar of current liabilities. Statistics on 189 representative companies in various industries show the following average working capital ratios from 1914 to 1924:

Working Capital Position of 189 Representative Companies in Various Industries.[2]

(All sums shown in Millions of Dollars)

Year	Total Current Assets	Total Current Liabilities	Net Working Capital	Ratio
1914	$2,410	$ 643	$1,767	3.75
1915	2,800	776	2,024	3.61
1916	3,626	981	2,645	3.70
1917	4,931	1,805	3,126	2.73
1918	5,795	2,248	3,547	2.58
1919	6,054	2,115	3,939	2.86
1920	6,558	2,330	4,228	2.81
1921	5,296	1,423	3,873	3.72
Increase of 1921 over 1914	$2,886 120.0%	$ 780 121.4%	$2,106 119.0%	

[2] James H. Bliss, Financial and Operating Ratios in Management.

It can readily be seen that for a loaning banker to extend accommodations based purely upon fixed ratios between current assets and current liabilities would be folly, and that it is essential that in considering the commercial borrower's claims for credit, he should take into consideration the important factors affecting the amount of working capital needed by the particular business. From the borrower's point of view, it is essential that he appreciate the requirements of his particular type of business.

Determining Amount of Capital Needed.—The following are some of the more important factors which will aid the borrower in determining the amount of capital needed by a business.

1. The length of time required to produce and market the product is of prime importance. In some industries, as in ship-building, for example, many months elapse between the original purchase of the raw materials and the sale of the finished product. This necessitates large outlays for labor and material which call for the maintenance of large amounts of working capital. In many lines of business time is a necessary element in the production process because of the nature of the product. This is illustrated in the case of hides, certain lumber products, and certain of the extractive industries. It is also true that where a long time is required for the manufacturing process the fluctuations in prices may cause great fluctuations in profits, thus requiring a large amount of working capital in order to provide against such contingencies. At the other end of the scale is the example of the bakery, in which the length of the production and marketing periods totals but one day.

2. When a business is seasonal in nature more working capital is required, other things being equal, than an "all year round" business. The rubber industry and the clothing industry illustrate the problem here. On the other hand, the publishing business is perhaps less affected by the seasonal fluctuations, depending in each case, upon the field engaged in. The author has seen highly seasonal enterprises started that ultimately required three times as much working capital as was originally contemplated.

3. Companies which normally manufacture largely after orders have been received, or which have contracted for the sale of their entire output, will require relatively less working capital than those which manufacture simply for the market. Again, a concern may do a large volume of business through an arrangement with a manufacturing plant to furnish a certain product which does not require payment under the terms of the contract until the receivable created has been liquidated. Further, there are some companies, like The Automatic Telephone Company, which sells its entire output to the American Telephone and Telegraph Company.

4. The turnover of merchandise determines to a large extent the amount of working capital needed. The more rapid the turnover, the greater the volume of business which can be done with a given amount of working capital. A slow turnover calls for a higher amount of working capital. At one extreme is the news stand, in which the entire stock is turned over several times a day, while at the other is the jewelry business with an average turnover of 1½ times per year.

5. When, because of scarcity, uncertainty, or transportation difficulties, it is necessary to purchase materials greatly in excess of immediate requirements, a correspondingly larger amount of working capital will be required.

6. The general type of business carries some considerations in itself. A jobber has a different working capital problem, ordinarily, than a retailer, or a producer, although a producer who does his own distributing must consider many of the financial problems of the jobber also.

7. The phase of the business cycle exerts an important influence. In periods of great price uncertainty a larger proportion of working capital is absolutely essential to a business. Either when prices are very rapidly rising or rapidly falling, a concern can be sure of avoiding financial embarrassment only by conserving its capital and keeping a wide margin between current assets and current liabilities. The former are constantly in danger of shrinkage, while the latter increase of their own momentum. When prices rise rapidly, a company's book profits apparently increase in a desirable manner. It will be found, however, that this increase of the "net worth" of a business at such times is wholly misleading, since more and more money is needed to purchase new materials at the prevailing higher prices. As is well known, the price of finished goods tends to lag behind that of

raw materials needed by the producer of those goods. Consequently, at such times a concern should have a larger proportion of free and perfectly liquid capital in order to operate comfortably.

In times of falling prices, also, inventories tend to shrink with fatal rapidity, and frequently become utterly frozen as the market disappears. Receivables, too, become slow, while the percentage of bad accounts enormously increases. Under such circumstances the company needs a large free balance of quick assets in order to protect its solvency. During periods of war, even though the general price movement might not be particularly marked, yet because of the decisive influence of military and political events upon certain classes of prices, a larger proportion of working capital is needed for "insurance" purposes.

8. The general type of business is in itself of much significance. A concern which because of the nature of its business must carry a large inventory will need relatively more working capital in order to keep itself fully protected. On the other hand, the working capital requirements of a coal mining company, for example, which practically never has an inventory on its hands, are very low.

9. A rapidly expanding business usually reports a relatively lower amount of working capital than a well-seasoned business in the same industry. This, however, is not usually a healthy condition and in most cases indicates overexpansion.

10. The terms of purchase for goods bought will also influence the relation. A company to which liberal or long terms are extended, it being the custom of the trade not to press for prompt payment, can get on with a much smaller amount of working capital in proportion to its volume of business.

11. The terms of sale of the product are even more significant. A company which sells for cash does not need to invest its money in accounts or notes receivable, and hence can economize on working capital. The briefer the terms of payment, the more favorable the condition from this point of view. As a rule, a company must give more favorable terms to its customers than it receives from those from whom purchases are made. Prompter collections and briefer terms have, however, ordinarily increased the working capital of many a concern threatened with serious financial difficulties. The more liquid the current assets, the closer they are to cash, the less working capital will be needed.

12. Another important influence is the number of different "lines" or kinds of products dealt in. Where it is necessary for a concern to carry many different kinds of merchandise in order to supply the trade, it will probably find some of the "lines" slow moving, and consequently more working capital must be locked up in inventory.

13. Some writers refer to the "volume of business" as having an important influence on the amount of working capital required. Certainly it is true that a company actively operating and selling goods will need more working capital than a concern which is defunct or retrograding. However, the "volume of business" is merely a reflex of some of the other factors which have been mentioned. A concern which turns over its stock of goods rapidly and collects receivables promptly may do a larger volume of business and still require much less working capital than another concern whose volume is far less, but whose goods turn slowly.

14. The relation of working capital to total assets or to fixed assets depends further upon (a) whether the company owns or leases factories or real estate, (b) whether the company does solely a manufacturing business or solely a distributing business, and (c) whether the concern is an integrated business, combining under one management several different stages in the industry. It will be found, for example, that such companies as the International Harvester Company normally carry a very high proportion of their assets in the form of working capital. In many lines of industry, such as candy making, shoe manufacturing, and the like, it is customary to lease buildings and in the latter case to lease machinery as well. Under such circumstances the fixed assets of the business will bear a very small proportion to the working capital. This is also a frequent condition in many retailing establishments.[3]

The foregoing are some of the factors the borrower should bear in mind when analyzing a balance sheet so that it may be seen in true perspective. But in summing up the previous discussion, it is fitting to observe in conclusion that with all the divergence in working capital requirements and criteria for valuing assets and liabilities, the borrower should ever bear in mind that the banker, when passing on a credit extension, considers first, immediate liquidity and second, ultimate liquidity.

[3] E. E. Lincoln, Applied Business Finance.

Unless the loan official of a bank is satisfied that there is a sufficiently wide margin of safety between the current assets on the one hand, and the current liabilities on the other, taking everything into consideration, he will not extend accommodations.

Borrower's Current Ratio and Supporting Ratios.—During what might be called the rudimentary stage of bank loan procedure, before the advent of the credit department in banks, a time when bank relationships were much more personal in character than they are today, bankers and trade creditors confined their analysis of financial statements almost solely to finding out whether or not the "current ratio" was satisfactory. If a company's statement showed that current assets were at least twice as great as current liabilities, there was a tendency to draw the conclusion that the financial condition was probably satisfactory.

The last few years have brought about many wholesome changes in the direction of more scientific and thorough investigation of the risk. During an interview the credit manager of one of the largest Federal Reserve Banks regarding his attitude toward the two for one ratio said: "For a banker or business man to pass on a statement just because it showed a ratio of current assets against current liabilities of two for one, is just like taking chloroform. With the complex nature of business undertakings today, more attention must be given to analyzing credits on statistical data. The impersonal character of the relationship between the modern banker and his clients makes this imperative, out of mutual fairness and protection. "However," he continued, "we still hear considerable about the 'two to one' ratio, especially in rural quarters."

With the banker and his clients growing more familiar with credit analysis every day, it will not be long before the fallacy of a mere two to one current ratio will be sufficiently exposed to make it possible for the borrower to get a sounder

adjudication of his credit application, and for the banker to extend accommodations with the minimum of loss and the maximum of helpfulness to his clients.

The ratio of current assets to current liabilities taken alone, then, is no criterion by which bankers may judge credit risks. It is rather to be looked upon more as a yardstick for measurement, than as a rule which may be applied in passing upon the figures presented in a financial statement.

By some the ratio of two for one is considered the starting point for comparisons. It is the experience of credit investigators generally that the current assets, as revealed in financial statements, in the event of liquidation, show a shrinkage of substantial proportions. It is a human weakness to overrate one's assets, to be over-optimistic in presenting merchandise figures, accounts receivables, and notes receivables, and other supposedly current assets. This tendency has already been pointed out in the discussion. Too often when a corporation gets into financial difficulty and a liquidation takes place, there may not be 10 cents on a dollar realized. Hence the margin of safety established arbitrarily at two for one, or two dollars of liquid assets for every dollar of quick liabilities.

Where the practical application of this rule falls down is in its inelasticity. A ratio which is satisfactory in one type of industry may be wholly inadequate for another. Again, the rapidly growing business would be expected to have a different ratio than a well-seasoned enterprise. Furthermore, a ratio which is sufficiently high in one period in the business cycle may be dangerously low in another period. General business conditions, the character of the business itself, the efficiency of the management, and the age of the business, may vitally affect the current ratio, showing a wide variation at different seasons of the year.

Other Ratios Throwing Light on Current Position.—It, therefore, becomes important to discover other relations which

will throw further light upon this ratio with a view to examining the direction in which the current ratio is traveling, rather than merely to study the percentage at which the current ratio rests. It is not so much a question of quantity as of quality—not so much a question of mathematical proportions as of harmonious combinations of values as particularly related to the enterprise in the light of all the circumstances of its environment and the conditions influencing its progress. The following ratios will enable the grantor of credit and the borrower to form a more correct opinion as to the strength of the current position:

1. The ratio of current assets, minus inventory, to current liabilities is considered a significant one, since it is by means of the cash and immediately maturing receivables that current liabilities must be met. This ratio gives the credit man a close appraisement of the quality of the current assets. When a balance sheet shows a ratio of current assets, minus the inventory, to the current liabilities of two for one, or better, then the statement is said to have passed the "acid test." While it is interesting to apply such a test to a financial statement, it merely serves as a financial yardstick; and there might conceivably be a large number of companies which, by the nature of their business, have much of their assets tied up in inventories which might be able to show a good statement with the inventory, but which might not make such a strong showing without it, and yet might be a good banking risk. On the other hand, a concern might pass the so called "acid test" and yet have current assets listed in their inventory which were well-nigh worthless.

For example, a glance at the table in Figure 7 shows that in 1922 there were 139 failures in the cloak and suit industries. At this time such businesses carried large inventories which were greatly depreciated in value and could not be readily liquidated because of over-production, change in styles, and "dead" merchandise.

NATIONAL CREDIT OFFICE RECORD OF INSOLVENCIES FOR THE YEARS 1921-25 ACCORDING TO DIVISIONS OF THE TEXTILE TRADE

		1921					1922					1923					1924					1925				
LIVISION OF TRADE	Number Con-cerns	QUARTERS				YEAR	QUARTERS				YEAR	QUARTERS				YEAR	QUARTERS				YEAR	QUARTERS				YEAR
		1st	2nd	3rd	4th	Total	1st	2nd	3rd	4th	Total	1st	2nd	3rd	4th	Total	1st	2nd	3rd	4th	Total	1st	2nd	3rd	4th	Total
Mfrs.Clks. & Suits	2330	10	12	26	55	103	38	26	44	31	139	17	16	17	30	80	18	33	21	26	98	18	23	14	37	92
Mfrs.Mens Clothing	2813	21	17	29	57	124	26	26	49	28	129	20	22	27	29	98	17	25	17	28	87	15	18	18	36	87
Mfrs.Wsts. & Dresses	2957	36	33	51	72	192	71	56	50	37	214	32	34	20	22	108	25	20	25	30	100	26	29	34	35	124
Jobbers Knit Gds.	3098	18	12	21	41	92	34	33	20	33	120	35	18	15	30	98	17	27	24	30	98	23	20	8	27	78
Misc. Cottons	6240	19	16	15	26	76	19	16	17	7	59	5	5	13	15	38	21	24	37	21	103	28	28	23	24	97
Misc. Silks	4251	16	7	9	8	40	5	2	1	6	14	3	3	3	2	11	29	28	20	35	112	30	17	23	43	113
Misc. Woolens	1600	28	15	18	47	108	16	8	5	6	35	3	4	6	15	28	8	4	5	4	21	8	3	6	8	25
TOTALS	23289	148	112	169	306	**735**	209	167	186	148	**710**	115	102	101	143	**461**	135	161	149	174	**619**	142	138	126	210	**616**

TOTAL NUMBER OF FAILURES FOR EACH DIVISION OF THE TEXTILE TRADE BY YEARS

	1921	1922	1923	1924	1925
Cloaks & Suits	103	139	80	98	92
Clothing	124	129	98	87	87
Waists & Dresses	192	214	108	100	124

	1921	1922	1923	1924	1925
Jobbs. Knit Gds.	92	120	98	98	78
Misc. Cottons	76	59	38	103	97
Misc. Silks	40	14	11	112	113

	1921	1922	1923	1924	1925
Misc. Wns.	108	35	28	21	25

Figure 7. A Record of Business Failures Compiled by the National Credit Office

Receivables, on the other hand, are generally found to be a more dependable asset if there are no questionable notes, providing the terms of sale are satisfactory and the credits wisely taken. Yet, banks sometimes find them "slow," and thus the acid test might also prove misleading as a basis for testing the financial position of the borrower. Bankers agree generally that it is desirable to have the cash and receivables at least equivalent to current liabilities, and when such is the case, everything else being satisfactory, the position is regarded as financially healthy.

2. A most important relation is that existing between sales and inventory. This involves the question of turnover. Whether or not this ratio is a definite index to the activity of a company's business depends upon the character of the enterprise. Some concerns consume a great deal of time in the various processes of production and, therefore, must carry a heavy inventory. Again, others buy in relatively small quantities, and turn their stock very rapidly.

For example, the following illustrative table shows the turnover of total assets in different industries during the years 1914 to 1926.

TURNOVER OF TOTAL ASSETS [4]

Industry	1914	1915	1916	1917	1918	1919	1920	1921	1922	1923	1924	1925
(7) Petroleum....	$0.30	$0.32	$0.38	$0.36	$0.45	$0.46	$0.50	$0.42	$0.45	$0.51	$0.45	$0.49
(14) Copper mining, smelting and mfg.....	.62	.68	.95	1.06	.90	.56	.67	.13	.17	.20	.18	.26
(10) Automobile and truck mfrs.	1.29	1.35	1.33	1.08	.95	1.09	1.01	.73	.76	.88	.74	.93
(8) Iron and steel	.30	.38	.58	.69	.68	.45	.52	.29	.34	.41	.37	.46

It will be noted that the turnover for automobile and truck manufacturers was greater than in that of petroleum and iron and steel industries which are slower-moving. The two extremes would be the case of a magazine stand with a

[4] Furnished by Babson's Statistical Bureau.

daily or weekly turnover, on the one hand, and that of a manufacturer of heavy machinery, on the other.

Yet, by comparative analysis the credit grantor is able to determine whether a concern's merchandise is being sold with reasonable promptness. It is customary for well-managed concerns in the trade to turn their inventory 4 or 5 times per year. Therefore, a business which shows on its balance sheet merchandise sufficient for 5 or 6 months will be open to serious question, no matter how favorable the current ratio. Often a poor ratio indicates weak management, lack of judgment and vision. The bank loaning official, therefore, carefully weighs the various causes for high inventory.

3. The ratio of sales to receivables is very significant in that it shows definitely the terms of sale in a particular business, or the promptness of collections. When the terms of sale are known to the banker, he can determine readily whether the company under consideration has an efficient collection department. Naturally, if the longest terms of sale are 60 days, it may be presumed that there should not appear on the books, receivables as high as 2 months' sales, inasmuch as many customers would be inclined to pay their bills in a much shorter time to take advantage of the discount offered.

Suppose a company makes annual sales of $2,000,000 with terms of sale in the trade being 2% cash, net 30 or 60 days, and shows $600,000 worth of receivables. Its credit position might be immediately questioned.

In some instances high receivables are due to adverse conditions existing in an industry which have caused collections to slow down, with consequent increased inability to meet liabilities in the usual manner.

Figure 8 shows the statement of a farm implement company during the deflation period of 1920-1921, when conditions were not normal. It will be observed that there was an increase in both notes receivable and notes payable. This was due to the rapid decline in the prices of farm products,

CORPORATION FARM IMPLEMENT COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	11/1/19	11/1/20	11/1/21
Quick Assets	2,137,234	2,467,876	2,636,703
Current Liabilities	191,717	230,474	645,779
Ratio Q. A. to Liabilities	11.13 to 1	10.77 to 1	4.08 to 1
Surplus Quick Assets	1,945,517	2,237,402	1,990,924
Other Assets	396,841	406,345	412,938
Total Assets Less Current Liabilities	2,342,358	2,643,747	2,403,862
Less Mortgages and Reserves	60,608	70,461	
Net Worth	2,281,750	2,573,286	2,403,862
Capital—Preferred	500,000	500,000	500,000
Capital—Common	500,000	500,000	500,000
Surplus	1,281,750	1,573,286	1,403,862
	2,281,750	2,573,286	2,403,862
Total Sales	[Sales	not	available]
Net Profit or Loss			
Dividends Paid			
Chg'd off, depreciation and bad debts			
Carried to Surplus			
QUICK ASSETS:			
Cash on hand and in bank	76,233	291,467	68,853
Notes Receivable	488,563	479,938	632,648
Trade or Bank Acceptances			
Accounts Receivable	22,118	101,468	20,852
Mdse. finished	1,185,520	1,378,653	1,914,350
Mdse. unfinished			
Raw Material			
Listed Stocks and Bonds	364,800	216,350	
OTHER ASSETS:			
Real Est. Plant, etc	265,958	258,228	264,928
Machinery and Tools	125,995	138,967	139,617
Goodwill, Patents, Patterns, etc	100	100	100
Due from Officers, etc			
Unlisted Stocks and Bonds			
Deferred Charges			
Teams, Fuel, etc	4,788	9,050	8,393
CURRENT LIABILITIES:			
Notes Payable	96,835	134,371	531,053
Trade or Bank Acceptances			
Accounts Payable	44,867	44,176	63,333
Individual's Deposits			
Dividends & Com	50,015	51,927	51,393
OTHER LIABILITIES:			
Mortgages			
Reserve Accounts	60,608	70,461	
	Outstanding with Commercial Paper Houses 4/1/21		210,000

Figure 8. Statement of Farm Implement Company during a Deflation Period

which made it impossible for many farmers to immediately liquidate their obligations. Thus the implement and similar companies were compelled to take more notes receivable, and to give more notes payable because of their inability to liquidate promptly, in turn, their own bills payable.

Fertilizer companies, farm implement manufacturing concerns, and enterprises selling goods on the installment plan, all generally take notes from their customers or dealers which they carry for long periods of time. Obviously, the turnover is slow, making necessary relatively more permanent working capital with which to operate. Such concerns are often found to show an unusually high current ratio because of the unliquidated condition of a large portion of current assets in the form of receivables. On the other hand, the 5-and-10 cent stores which have no receivables, only show cash and quickly turning merchandise on their financial statement.

4. The ratio between receivables and merchandise has sometimes been found significant for special lines of business.

Take the illustration of the retail lumber and building material company for the years 1925-1926, shown in Figure 9. The increase in notes receivable to $216,554 indicates a weakened credit position, inasmuch as the company was unable to make prompt collections and was compelled to take notes instead of cash. It is observed that during the year 1925 there were less notes receivable. Such a drastic change requires questioning on the part of bank loan officials before granting accommodations.

5. The ratio of notes receivable to accounts receivable is also worthy of careful scrutiny. In many lines of business goods are sold on account, and notes are not received in payment at the time of sale. Therefore, it is expected generally that the accounts receivable will be considerably larger than the notes receivable.

In the statement of a wide print cloths company shown on page 421, the large item of notes receivable, as compared to

CORPORATION RETAIL LUMBER AND BUILDING MATERIAL CO.

Comparison of Statements

CONDENSED STATEMENT:

Date	12/31/25	6/30/26
Quick Assets	631,877	666,520
Current Liabilities	231,773	288,703
Ratio Q. A. to Liabilities	2.72 to 1	2.31 to 1
Surplus Quick Assets	400,104	377,817
Other Assets	105,525	99,850
Total Assets Less Current Liabilities	505,629	477,667
Less Mortgages and Reserves	25,449	
Net Worth	480,180	477,667
Capital—Preferred	50,000	
Capital—Common	300,000	351,500
Surplus	130,180	126,167
	480,180	477,667
Total Sales	933,781	
Net Profit or Loss	59,491	
Dividends Paid	none	
Chg'd off, depreciation and bad debts	available	
Carried to Surplus		
QUICK ASSETS:		
Cash on hand and in bank	36,455	28,473
Notes Receivable	30,060	216,554
Trade or Bank Acceptances		
Accounts Receivable	379,931	209,586
Mdse. finished	214,190	210,324
Mdse. unfinished		
Raw Material	1,300	1,583
Listed Stocks and Bonds		
OTHER ASSETS:		
Real Est. Plant, etc	72,108	60,039
Machinery and Tools		
Goodwill, Patents, Patterns, etc		
Due from Officers, etc	26,667	26,746
Unlisted Stocks and Bonds	2,000	1,000
Deferred Charges	4,649	12,065
CURRENT LIABILITIES:		
Notes Payable	186,800	230,600
Trade or Bank Acceptances		
Accounts Payable	37,864	32,883
Individual's Deposits		
Res. for Taxes	7,109	25,220
OTHER LIABILITIES:		
Mortgages		
Reserve Accounts	25,449	

Figure 9. Retail Lumber and Building Material Company Showing Large Amount of Notes Receivable

that of accounts receivable, indicates the probability that over-due accounts have been settled by means of notes. Such situations are apt to arise in times of financial stringency. While it has already been observed that in some lines of business it is expected that notes be taken in payment, and that in consequence the item of notes receivable will exceed that of accounts receivable, still it is necessary to take into consideration the type of business to justify the existence of large amounts of notes receivable on the statement; and under normal operation one does not observe a statement without any notes receivable one year and a large amount the next year, without wanting an explanation as to the reason for the drastic change.

6. The ratio of notes payable to accounts payable also requires careful attention as one of the supporting ratios. From the statement of steel mill manufacturing sheet metal products, shown on page 423, it can be seen that notes payable are far in excess of accounts payable, which have become less than the year preceding. In order to determine whether this is a desirable condition, it is necessary to analyze the notes payable item to show whether they have been issued to merchandise creditors, banks, note brokers or to others. If upon investigation it is found that they have been issued to merchandise creditors in payment of over-due accounts, or have been issued to officers or outsiders to obtain funds because the bank credit of the company is limited, an unfavorable financial condition is indicated. On the other hand, if the item represents funds obtained to take the discount on goods purchased for current needs, the same criticism would not hold and the item might possibly exceed accounts payable. Yet, when there is such a marked increase as shown in the statement, it requires an explanation.

7. The ratio of sales to working capital also deserves some consideration. This ratio is extremely interesting when viewed over a period of years, and is a good reflection often of the ability of the management. If inefficient use is made of work-

ing capital, naturally it will not be possible to make the same volume of sales, inasmuch as the capital, if tied up in other than working assets, will not be available for sales promotion. It throws light on sales and financial policies, and can be used in some cases to measure a concern's progress over a period of years.

8. A careful scrutiny of the ratio of sales to tangible "fixed" assets over a period of years makes it possible to form an opinion of the direction in which a company is tending. Suppose, for example, a company increases its plant account, its investments in subsidiaries, and other permanent assets, more rapidly than the volume of sales in dollars. Very often it will be found that the company is over-expanding.

Take the case of the Goodyear Tire and Rubber Company. The comparative balance sheet and income statement of this concern showed that about 1917 the company began rapidly to increase its fixed investment out of proportion to its immediate volume of business. It is interesting to note that in 1919 the net sales were over 4 times the fixed assets; but that in 1921 when net sales fell down to $82,000,000 the ratio of fixed assets to sales became too great. The company had too much of its capital tied up in its plants and fixed or permanent investments.

9. An indication of the owner's investment in the business may be found in the ratio of sales to net worth. If the ratio is found to be abnormally high it may be that the concern is trying to do too much business on borrowed capital. Again, in some instances it shows great economy and skill in the use of capital, depending on the circumstances. Like the other supporting ratios, to be appreciated it must be taken in the light of the others. The turnover of capital is also interesting from the standpoint of determining potential earning ability. The greater the turnover, the less capital required and hence the possibility of greater profits.

10. A most interesting ratio is the operating ratio. It

shows the relation of the total expenses of operation, including the cost of materials, selling, general and administrative expenses, to the net sales. Providing one can be certain of the way in which operating accounts are kept, this ratio might be of as much significance as a yardstick for measuring the relative efficiency of one business against another in the same line of industry under about the same circumstances of operation. The more rapid the inventory turnover, the higher the operating ratio. Generally the operating ratio runs about 90%, but in some packing concerns it has been known to go as high as 99%, which is excessive.

11. Sometimes the ratio of cash to current assets is considered of great significance in estimating a concern's immediate solvency. Take a company doing a large volume of business with wages and bills maturing as the company progresses. If the cash carried is too small the company may find itself financially embarrassed before its outstanding accounts can be realized on or their equivalent raised in cash to tide over the stringency in cash.

On page 461 is the statement of a provsion company which shows only $13,000 in cash near the end of 1926. A discount committee of a bank when scanning this balance sheet did not consider the amount shown adequate for this type of business and the company was rejected.

Ordinarily it is customary for banks to require compensating balances of 20%. Moreover, since the average company borrows from the bank to take the discount on purchases, thereby reducing accounts payable, it is generally conceded by bankers that the amount of cash in the current assets should be at least 20% of the current liabilities, or 10% of the current assets. Cash balances ordinarily should show a minimum of 5% or 6%, and a maximum of 20 to 25% of the current assets. Yet, in the face of heavy borrowing a company will often show only 10 to 15%, owing to the heavy need for cash in the peak of operations.

12. The ratio of net worth to working capital has at times been thought important. When the net worth is high in comparison to working capital it shows strong ownership in the business; when small it may indicate that the business is operating on borrowed capital. Ordinarily a bank likes to see the net worth 2 or 3 times the working capital, although this would not give any definite assurance that the net worth shown is represented by liquid assets.

13. Most significant is the ratio of net income to net worth. It is important to know how much a company is earning on the owner's equity in the business. The fact that proprietorship continuance will depend largely upon the net profit to the owners of the business is important to the lending bank which is to put temporary cash into the enterprise. Otherwise it might be that the owners would attempt to liquidate at the bank's expense owing to their lack of satisfactory return on the capital they have personally in the undertaking.

From the foregoing it becomes obvious that the "two to one" ratio of current assets to current liabilities can be regarded as merely a mark at which to aim. Taken by itself it means almost nothing. There are conditions under which a fifteen to one ratio would be thoroughly unsafe as a basis on which to make commercial bank loans; there are also circumstances under which it might be advisable to make unsecured loans when the ratio falls almost as low as one to one.

Consider a personal service corporation which has nothing to sell but its services, and has naturally nothing in liquid inventories or other quick assets, perhaps, outside of its accounts receivables. The statement might be only one to one. Yet they might be entitled to accommodations in spite of this. Take also the case of a public utility corporation and similar types of business. The nature of the enterprise is such that they would have most of their assets tied up in rolling stock and equipment showing a one to one statement, yet they might

be a good risk such that banks would gladly extend accommodations.

The comparisons noted above serve, with the illustrations, to call attention to the fact that the financial aspect cannot be dissociated from the manufacturing and merchandising aspects of the business. The first must be related to and considered in the light of the other two. The number of days' merchandise on hand determines the quality of the receivables and merchandise respectively, and so indicates the degree of liquidating power which each possesses. The various points in the analysis undertaken must be judged in the light of the conditions in the industry as a whole, which are given in part by the type ratios, but must be supplemented by a more general knowledge of the applicant's business practices. The greater the knowledge possessed by the borrower, the credit man, and banker, the better the basis for their judgment.

CHAPTER VIII

ANALYZING THE BORROWER'S CURRENT ASSETS

Adequate Cash Necessary.—Every concern has to estimate its cash requirements to meet the daily needs of its business. The making of sales, the production of goods, and the securing of equipment and personnel, all involve an expenditure of funds. All these operations must be financed, and they can be carried on only to the extent that the financial resources of the company will permit. It is only logical, then, that the loaning banker scrutinizes the balance sheet carefully with a view to judging whether or not there are adequate cash balances and, therefore, the first point for discussion in relation to the current assets of a business is the cash balance requirements.

Budgeting Ahead for Cash Balance Needs.—First of all it is important to know whether the bank balances are ample to care for the business operations involved. That sufficient cash be available, every conservative, well-organized company should, by aid of statistical data, estimate its present and future requirements.

If such an estimate is made, when the executive in charge of finances comes into the bank for a loan, he is in a position to state his cash requirements. If he is judging his bank balance requirements by guess-work, then he will not. In order to arrive at a well-rounded conclusion as to just how much cash will be needed, some of the more essential questions to be determined are:

1. What are the estimated cash receipts to be realized from the operations of the business during the budget period?
2. What are the prospective plans of the directorate, and what will their plans require in the way of cash balances? Loans from banks, and funds to be realized from the sale of stock or of bonds must be excluded.
3. What are the estimated disbursements for operating purposes? This can be ascertained by estimating cash disbursements, excluding disbursements on bond payments or retiring long-term obligations, such as notes. This estimate also necessarily requires consulting the directors' plans.

When the borrower has estimated as closely as possible all his cash receipts from all sources, and the estimated cash disbursements for all purposes are determined, the estimated cash balance can be ascertained.

Now, it often happens that when the estimated cash balance is approximated, the borrower finds that he will have to make some adjustments in his financial program to provide enough cash to carry him over. If the cash estimated to carry out proposed plans for any given period seems to be difficult of realization, often the foresighted management will curtail their output and operations sufficiently to keep their financial equilibrium.

Consultation with a banker often aids the borrower in formulating his plans, and the financial advice obtained from experienced loan officers has frequently made it possible for depositors to build up their cash balances to such a point that they have not found it necessary to ask for any accommodations.

Analyzing the Cash Account.—The cash account is divided by accountants into the following: cash in bank (de-

posits), cash on hand (petty cash fund), and cash in hands of branch managers.

However, the banker in analyzing a concern's cash account wants to know not only what kind of an account is represented, but what is included in it. He wants to know whether there are included such items as demand notes or I. O. U.'s covering withdrawals, expenses, or loans to members or employes of the concern. The banker looks upon the custom of carrying such items in the cash account as an unfavorable sign.

Because confidence is easily shaken by careless, or irresponsible errors in setting up these items correctly, it is appropriate to point out here some of the things the borrower should watch. Where cash is held in the bank subject to withdrawal only upon several days' notice, it should be shown in the balance sheet. Again, overdrafts should be shown as current liabilities. Proceeds from the sale of capital stock usually should be shown separately, because they cannot as a rule be used to pay ordinary current liabilities, but are presumably being retained to make extensions or to refund long-term debts. Where capital stock is sold to provide working capital, this segregation is unnecessary.

Guaranty Deposits.—Guaranty deposits represent cash, but as it is not free cash, the borrower should always be sure that the amount of money deposited with cities, corporations, or individuals or contractors, for the purpose of guaranteeing the fulfillment of a contract, is separated from the contractor's regular cash in bank, and is set up as a separate item on the balance sheet.

Escrow Deposits.—It is essential to learn also whether any funds represented in the cash account are anticipated to be paid out in settlement of a suit, or in relation to some business negotiation. Such amounts may be in the form of a certifi-

cate, and in such cases they should be set up as a certificate of deposit so that the banks will know definitely what they represent.

Petty Cash Fund.—It is important to know whether any part of the cash is petty cash. Amounts such as are needed for petty expenses, which cannot conveniently be settled by checks, are provided for by means of the petty cash fund kept in a cash drawer or safe. Some concerns hold out a part or the whole amount of the cash receipts of the day to build up their petty cash account. Others deposit all in the bank, which is safer and more business-like wherever it is practicable to do so.

Imprest Fund.—The credit man wishes to ascertain whether any funds in the cash account are held by affiliated or subsidiary companies under the so-called "imprest cash system," or whether it is held by concerns in the process of liquidation.

The imprest fund is usually kept up to a certain fixed amount by subsequent checks which are deposited for that purpose. But the banker wants to know just what is included under the heading, whether it wrongfully includes sums advanced to subsidiaries in exchange for materials, or irregular sums advanced for some other significant reason, which might be of great importance to the banker in considering the applicant for a loan.

Bank Balances.—In considering the amount of bank balances the banker also considers the effect of general conditions prevailing in the business at the time of making the statement. Preceding distribution periods for dividends or bonuses, the balances may be out of line, in which case the borrower might do well to disclose this fact that it may be taken

into consideration. In some states, there are heavy taxes on bank balances. This accounts for the low balances often appearing on the balance sheets of concerns operating in these states.

In the analysis made of the offerings of fifty companies rejected by the discount committees of banks throughout the country, the results of which are shown in the table on page 390, it is of interest to note that there were two concerns which were refused financial support because of too low bank balances.

One of these was a provision company whose balance sheet is given on page 461. It shows too low bank balances in proportion to the financial set-up and the possible requirements of the business.

Accounts Receivable.—Most important of all, from the point of view of liquidity, are the borrower's receivables. Because the banker looks for the payment of his notes at maturity, or within a reasonable time, he scans the borrower's receivables closely, for it is from them the cash is to come that is needed to clean up bank loans outstanding at the end of the fiscal period.

The accounts receivable represent to a large extent the margin of safety between the other current assets and current liabilities, thus from a banking angle they are of primary significance. It is not an uncommon occurrence for receivables to go bad, get the client into financial difficulty, make it impossible for him to pay up his bank loans and, in consequence, cause a severe loss to the banker.

Considered as a barometer, receivables indicate the flow of a business. If a graph or chart is made of them so that they may be compared monthly or yearly, interesting sidelights on a concern's financial condition are revealed, which, if taken advantage of by the merchant-borrower, will help him to steer a sound financial course; and if heeded by the wide-awake

banker, will assist him in appraising a company as a financial risk.

Basis for Analyzing Accounts Receivable.—In finding the right basis for analyzing accounts receivable, the student of finance must classify them in logical order which will make it possible to throw some light upon their character and quality. The borrower should clearly distinguish between the following kinds of receivables, and present them separately on the balance sheet, so that the banker may know how liquid the accounts are:

1. Accounts receivable due from merchandise.
2. Accounts receivable due from employes for advances made to them.
3. Accounts receivable due from subsidiary companies and branches for merchandise shipped to them or for advances made to them.

James O. McKinsey, in suggesting this classification, says that there are two reasons why such a division will help the borrower in following it:

1. If the customers do not pay their accounts, collection can usually be secured from them by legal process, while it is usually not expedient to bring legal action against employes or subsidiary companies.

2. In determining the ratio of accounts receivable outstanding to sales, it is necessary that only the accounts arising from sales be used.[1]

With the foregoing classification in mind, it is proposed now to consider each division separately with a view to emphasizing some of the things which show up the true character of the receivables.

Accounts Due for Merchandise.—Just what should be listed as an account due for merchandise the borrower may

[1] James O. McKinsey, Bookkeeping and Accounting, Vol. II, Series A.

ask? The answer is, goods which have been sold unconditionally and to which the title has passed to the purchaser should be so listed.

Merchandise which has been lent or sent out on approval should unquestionably be listed separately. It would seem that it should hardly be necessary to mention this, yet one will occasionally find consigned merchandise out on approval in a prospective customer's home or office, or other merchandise out on trial, listed among the accounts receivable. Naturally, this is confusing and misleading, and while the practice is found only under circumstances of bad management or ignorance, when it does exist, it is most injurious to the borrower in the impression he leaves on the banker.

Accounts Due or Past Due.—It has already been suggested how important it is for the borrower to keep his accounts receivable fresh and accurately classified. The conservative merchant should always list accounts past due separately from those not yet due.

Experienced bankers find that when accounts receivable are "bunched" in the financial statement, when analyzed they will often be found to include some dead accounts. The writer bears in mind an analysis which was made to ascertain the condition of a firm's accounts receivable as a basis for credit accommodations. When the list was furnished by the bookkeeper it was requested that the date the goods had been delivered be entered after each account. When the check up was made, it was found that over 30% were past due and that fully 10% were more than 60 days old. That was all the bank wanted to know in this case. When the concern subsequently liquidated, as might well have been expected, a considerable number of the accounts proved of very questionable value.

To avoid confusing the banker, and thereby shaking his

confidence, the proper thing to do is to show whether all doubtful accounts have been charged off. Later, when they are paid up, the amount is credited to the correct account. A safe procedure to follow here is to set up a reserve for bad accounts.

Again and again, it is found that in periods of tight money, when business conditions are uncertain and collections are slow, an investigation of accounts receivable on a statement will indicate a slowing-up going on, which, if there is a shortage of working capital, may result in serious financial embarrassment.

The borrower by listing separately his receivables past due will be wide-awake to this condition, and be able to anticipate difficulty by forcing collections.

Receivables Due from Employes.—Perhaps the most curious and most interesting sidelight revealed in analyzing the receivables is found under the heading "Due from employes."

At times large sums are listed which have been advanced to employes for various purposes. Bank officials are suspicious when the items are large, and want to know just what the amount comprises, and the purposes for which the money was advanced. Distinct from accounts receivable due for merchandise, these amounts should be listed separately, showing the maturity, and what collateral, if any, was put up as security.

Receivables Due from Subsidiary Companies.—Funds due and receivable from subsidiary and affiliated companies should not be included in the quick assets, because while the amounts may be liquidated from time to time, they are often of a more or less permanent character, and frequently represent the actual working capital or the investment in the subsidiary companies.

Miscellaneous Receivables.—At times a statement will be furnished a banker which lists among the receivables amounts due from public institutions. The amount of red tape necessary to get money promptly from municipalities, local improvement boards, and the like, is such that it is necessary to have a large working capital to continue in the service of public corporations. Bankers often find that through legal setbacks, and other clerical and financial circumstances, contracting companies installing lighting units, sewers, and other improvements are compelled to wait for several months before payment is made in full. This sometimes makes it impossible to meet the notes falling due at the bank.

An interesting example of this was illustrated by the statement rendered a western bank by a concern showing $286,000 due from state highway departments. When the statement came up before the bank's discount committee for the extension of credit this is what was disclosed. "It was reported that the company had been slow in certain instances in meeting its trade obligations, and we were also informed that some of its receivables are due from state highway departments, which, while good, as a general rule are not always paid promptly." When considered in view of all the circumstances, it was decided not to take on the account.

Analysis from Size and Number.—Most interesting is an analysis of the accounts receivable from the point of view of size and number. While it might be said that to have a few large customers is an advantage from the point of view of economical operation, still there is truth here in the old axiom that there is safety in numbers.

The writer recently had an example brought to his attention of a large eastern manufacturing concern which had employed a middle western firm to handle its advertising. A change in policy made it advisable to switch agencies and, as a

result, the advertising firm which had maintained its organization on a very few but highly rated clients, was so impaired that it was practically compelled to liquidate its business.

Bankers have so often observed unfortunate instances similar to the one just cited, that they prefer a customer's statement which has a well-distributed list of moderate-sized customers. While the clerical work incident to handling a large number of small accounts may be quite an item of expense, still there is a certain evenness of operation; and the loss of any client or customer does not strike such a blow to the organization, as is often the case where there is but a relatively limited number of clients.

In the preceding chapter the ratio between the accounts receivable, and merchandise and sales, was discussed and what the relationship indicated to the borrower and his banker. Because a later chapter will be devoted to a detailed consideration of this phase of comparative analysis, no further space will be given to it here.

Hypothecated Receivables.—One of the most important points to be scrutinized, especially in cases where concerns are short of working capital, is whether the accounts receivable have been pledged in any way. In the sections relating to the part played by the certified public accountant, the necessity for setting up such accounts separately is pointed out, so that the banker may know for what the concern is contingently liable. When receivables are hypothecated, it is usually an indication of over-expansion.

Notes Receivable.—Some concerns use the term "bills receivable" as meaning the same thing as "notes receivable" but as some of these confuse "bills"—meaning promissory notes—with bills for merchandise purchased, the distinction is better preserved when the term "notes receivable" is used.

Ordinarily the term "notes receivable" means negotiable

promissory notes or accepted drafts received from customers in settlement of goods sold, not discounted, transferred or assigned. For a more detailed classification the reader is referred to the previous chapter.

While in many lines of business notes are taken for goods sold, it is necessary to look into the items appearing on the books, particularly if in large amounts, to ascertain whether or not the policy or type of business warrants the acceptance of notes, and whether or not the notes represent fresh receivables or are a mere cloak to conceal the weak debtor's slow payments.

Only such negotiable promissory notes as are not due at the time the statement is prepared and which the merchant-borrower actually believes, after diligent inquiry, will be paid by the maker at maturity, should be included. Over-due notes should be stated in a separate amount under "over-due notes."

When notes have been continuously renewed, unless fully secured by collateral or endorsement, or unless warranted by absolute knowledge of the financial responsibility of the makers or endorsers, they should not be appraised "good" for the full amount. It is generally agreed that if a debtor does not reduce the amount of his indebtedness within a reasonable time, he is not making good progress, and unless something unexpected turns up, his ability to meet his obligation may be lost. Moreover, in being honest with himself in his attitude toward appraising notes, the borrower will set up a reserve to take care of those notes which, many times renewed, may never be paid up.

Those whose business it is to examine financial statements find from experience that an abundance of notes in a balance sheet may at times indicate a weakened financial condition, or a changing sales policy. This is especially true where other than strictly trade notes appear, such as loans to officers or employes, subscriptions for stock, accommodation notes, notes

of affiliated concerns, hypothecated notes, and others which may be uncollectible in case of failure.

The condensed comparison of statements of a car manufacturing company shown on page 453 reveals how difficult it is to picture the condition of a business in its entirety when the actual amount of the customer's notes is obscured with miscellaneous obligations all under one heading. When an investigation was made relative to the extension of credit, a bank wrote in:

> We are unable to come to a very favorable conclusion as to the result of our research. You will note that while the company includes in its assets, trade acceptances and foreign accounts receivable that the auditors point out in their certification "trade acceptances as well as customers' accounts totaling $350,000 are due from companies undergoing receivership." Also, just how good the customer's notes under the heading "Foreign—Unsecured" are, is really problematical, unless it were known the sources from which these receivables are due.

If the reader will examine the comparative statement, he will find that it is not a bad one; yet the bank in question refused to extend credit. It took a searching investigation to bring to light the real facts back of the balance sheet as presented, there being no listing, separately, of "foreign customers' unsecured notes," which is shown in Chapter XIX, in order to reveal how important it is to present all the facts back of the figures, so that the banker may not get the impression that the borrower is trying to conceal anything.

From the foregoing considerations it can be seen that such items as notes of subsidiaries or allied interests should be listed separately. Moreover, notes representing capital expenditures are often misleading, and also should be set up separately. Whenever notes are taken by a parent company from a subsidiary for materials furnished, or for cash given out for current operating expenses, the uncertain character of these notes requires a separate listing.

Discounted Notes with the Bank.—What about discounting notes receivable with the bank? It is a generally accepted practice for banks to assist their depositors in turning their capital by taking in their good notes for account. It is important to know whether the notes brought in are from firms which are rated, making it easier for the bank to secure information on the maker of the notes, if such is the case.

In this connection, cases have been observed in which a company short of working capital became embarrassed through having its contingent liabilities (notes discounted at the bank) turn into direct obligations through non-payment by the makers on the notes. This often results in a bad financial situation for the firm which has temporarily eased its financial condition through the co-operation of the bank, only to find later that the funds it had anticipated did not materialize. It is to avoid such situations that the conservative banker looks well into the condition of the concern expected to make good on the notes. This is particularly true, if the customer asking for the discount has a statement which reveals a shortage of working capital. By checking carefully the firms from whom he accepts notes, before bringing them into the bank much trouble is saved for the borrower, who often injures his reputation by the unsound character of the paper he asks his banker to accept for discount.

Appraising the Merchandise.—The merchandise account, or that class of assets sometimes loosely spoken of as the inventory, will now be analyzed. In the previous chapter the merchandise account was divided into different classifications according to the type of business activity. It will be noted that the comparative statement form used in the illustrations shown later in this chapter, includes in its classification: finished merchandise, unfinished merchandise, and raw materials. Obviously, a mercantile concern, or a sales organization ordinarily will not list finished merchandise, or merchandise in

process, inasmuch as they are not manufacturing companies, and probably have on hand only "supplies." The borrower should list the character of his merchandise, whatever be its class and relative importance on the balance sheet, so that it will be readily comprehensible to the banker. Experience has proved that the borrower's tendency to manipulate the merchandise account, intentionally or otherwise, oftentimes opens the way to misleading statements which endanger the risk.

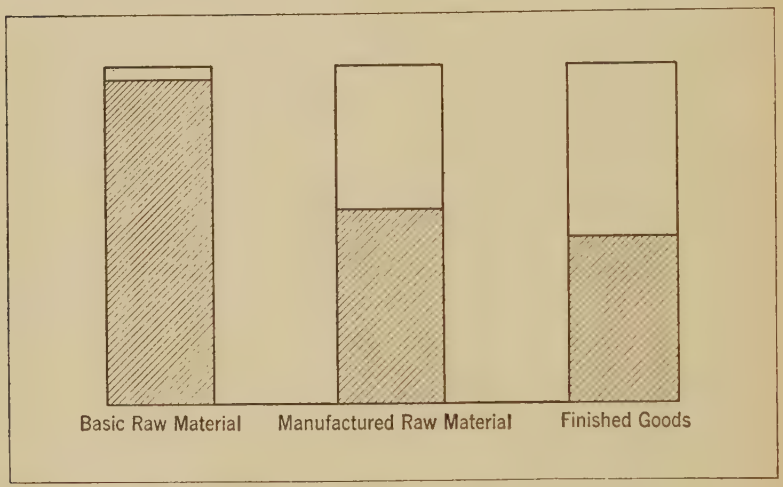

Figure 10. How the Banker "Weighs" Your Inventory

Under the section on supporting ratios, in the chapter on statements, the point was emphasized that merchandise is worth, not what it originally cost, but what it will bring and should be listed at cost or market, whichever is lower.

Right Basis of Valuation.—The banker's analysis of inventories depends a great deal upon the type of business, and the consequent character of the inventories, and whether the investigation is made for a going concern or to get forced-sale values.

In the illustration shown in Figure 10, there is a clear vis-

ualization of how the banker weighs inventories according to their classification to get forced-sale values. For example, "there may be two totally different types of manufacturers, judged from the standpoint of their inventories. One may be a manufacturer who uses basic materials, like ingot metals in a rolling mill. The other is the manufacturer who buys as his raw material the finished product of factories of the first type."

The raw material in the inventory of the manufacturer who uses mostly basic raw materials can be considered more nearly its inventoried worth than can that of the manufacturer who uses for his raw material the finished goods of another manufacturer.

If it is necessary to liquidate a business of this sort, the chances are that the raw materials can be sold right back on the market at practically no discount. For this reason, when analyzing a statement for this type of industry, the banker allows the figure submitted for this item to stand as it is, or, at most, with a discount of possibly 2% for miscellaneous charges, such as hauling charges, which might be incurred.

On the other hand, with an industry of the second type, it is considered that the raw-material item should be subject to a much larger discount. Castings that a manufacturer might buy cast to his own pattern may be worth 100 cents on the dollar to him as a going concern. But if the business must be liquidated, they have no value on the market except the scrap value of the metal they contain. This is true of stampings, sheet metal of various gages and sizes, and any other manufactured material. So the raw material figure for this type of business is discounted about 40%.

In any business, goods in process must ordinarily be finished before they have any sale value. And when a business is being liquidated all work has probably stopped. Only the scrap value of the goods in process remains. So, goods in process are considered to be worth next to nothing.

The item of finished goods is discounted about 50%. This discount is necessary because, on forced sale, a market would probably have to be found for them, as it is reasonable to suppose that under ordinary circumstances a manufacturer would not be liquidating if he had sufficient market for his goods. The chances are, therefore, that a canvass would have to be made of the wholesalers or other outlets

than he regularly has for his goods. And these, in turn, would have to be offered a bonus in the shape of an extra discount to take these additional goods on their shelves for cash.

Contrasted with manufacturer's inventories, however, the inventories of wholesalers and retailers consist entirely of finished goods ready for sale. Without doubt, most wholesalers and retailers have on their shelves lines that they erred in buying, lines which have not turned out as well or moved as quickly as they expected.

These goods, of course, on forced sale would be a complete loss, and the other goods would doubtless have to be discounted somewhat to get spot cash. But, as most of these businesses have on their shelves only staple articles, the inventory of the average wholesaler is discounted 20% and the average retailer 30%. Generally, the wholesaler is allowed a higher figure than the retailer because his outlets for disposing of his goods are ordinarily better. He depends for his sales on firms which buy in quantity rather than on individual purchasers whose buying whims are admittedly fickle.[2]

The foregoing merely indicates what can be realized at a forced liquidation, and does not take any stock whatever of the fact that any legitimate borrower who comes with a going business to the bank is entitled to list its inventories at cost or market price, whichever is lower.

In a later discussion there is set forth the right basis for arriving at a true valuation of merchandise. It is now proposed to point out some of the factors which reveal the financial condition of a company through a quantitative and qualitative discussion of inventories with a view to establishing an approach to sound financial procedure in commercial operations.

The Large Inventory.—Inventories may be revealed in a statement as either very large, normal, or very small, taking into consideration among other things the type of industry, the season of the year, and the stage of the business cycle.

From a banking angle, the size of an inventory is of prime importance. The effect of a large inventory on the working capital requirements of a business has already been noted. If

[2] Craig B. Hazlewood, vice-president The Union Trust Co., Chicago, "How the Banker Weighs Your Inventory," *System*, August, 1926.

a company's assets are tied up in an unusually large amount of goods, there must be a consequent depletion of cash which may hamper operations and result in financial difficulty.

The case is cited of a radio concern. A large manufacturing plant, having something like $100,000 tied up in copper wire, which, because of its character, was not readily marketable, became a temporary financial burden, because the company could not realize on it until the opening of the manufacturing season 6 months off. The result was that a shortage of cash placed the company in an awkward financial position, even though its liabilities were hardly more than $20,000.

Frequently a banker will go over the statement of a manufacturing company which has been reorganized. He often finds a large supply of merchandise on hand, much of which, upon investigation, proves to be obsolete. It may be phonograph motors, parts of obsolete models, materials made to peculiar dimensions or specifications, useless hardware, shoes out of style in odd lots, clothing or any other class of merchandise, and in an amount out of all proportion to the other figures in the statement.

Naturally, when a concern seeking credit pads its statement with merchandise which is worthless for anything but junk in liquidation, it does not greatly impress the banker or sound merchant. Experience reveals that a large inventory, under normal conditions, will only affect the condition of the company in so far as it can be turned, say, in 60 or 90 days into cash, depending upon the type of business and the terms of sale. It is not unusual also to find that a large quantity of left-over goods, which may be entered at cost price in the statement but if liquidated would be found to be of little real market value either to the merchant, or to the banker who is asked to pass on the statement for a loan.

Since the deflation the discussion of how large an inventory should be carried has become pertinent, and today the thinking merchant is continually on the lookout to see that he does not

CORPORATION — COFFEE MANUFACTURING COMPANY

Comparison of Statements

CONDENSED STATEMENT:

Date	9/1/25	9/1/26
Quick Assets	1,768,181	3,144,222
Current Liabilities	491,076	1,050,535
Ratio Q. A. to Liabilities	3.60 to 1	2.99 to 1
Surplus Quick Assets	1,277,105	2,093,687
Other Assets	746,774	1,350,595
Total Assets Less Current Liabilities	2,023,879	3,444,282
Less Mortgages and Reserves		
Net Worth		
Capital—Preferred		
Capital—Common	1,800,000	2,500,000
Surplus	223,879	944,282
	2,023,879	3,444,282
Total Sales	10,000,000	(1925)
Net Profit or Loss		
Dividends Paid		
Chg'd off, depreciation and bad debts		
Carried to Surplus		
QUICK ASSETS:		
Cash on hand and in bank	447,175	129,423
Notes Receivable	200,275	438,736
Trade or Bank Acceptances		
Accounts Receivable	531,496	963,231
Mdse. finished	589,235	1,612,831
Mdse. unfinished		
Raw Material		
Listed Stocks and Bonds		
OTHER ASSETS:		
Real Est. Plant, etc	649,973	1,205,457
Machinery and Tools		
Goodwill, Patents, Patterns, etc		
Due from Officers, etc		
Unlisted Stocks and Bonds	93,311	145,137
Deferred Charges	3,295	
Miscellaneous	192	
CURRENT LIABILITIES:		
Notes Payable	2,000	2,000
Trade or Bank Acceptances		
Accounts Payable	489,076	1,048,535
Individual's Deposits		
OTHER LIABILITIES:		
Mortgages		
Reserve Accounts		

Figure 11. Statement of a Coffee Company Showing an Abnormally Large Inventory

get "caught." A large inventory requires much working capital and is so risky to carry in a spotted market that bankers advise their clients to be conservative and buy only their requirements.

The illustration in Figure 11 shows the comparative statement of a coffee company. It was rejected by the discount committee of a bank because it revealed a heavy increase in inventory with prices of coffee at that time presumed to be at the peak, with the possibility of a drop in sight. The bank believed that a sharp fall in the coffee market might jeopardize the company as a risk, and did not care to grant accommodations for that reason.

The student of affairs may wonder why it is that abnormal inventories are accumulated, especially during periods when market conditions are known to be spotted, and there is a possibility of loss through deflation. The answer to this question is that it depends upon the nature of the business and the circumstances under which it operates. Some of the more important considerations leading to an over-inventoried condition are:

1. The lure of quantity discounts which often prove a big factor when a company is doing a big volume of business on a small margin of profit.
2. The saving in freight rates in special cases where it is cheaper to buy large quantities at one time.
3. The necessity, as in the case of specially rolled steel bars, to order in quantity to induce the supplier to make the rolling.
4. The purchase of large quantities may mean more favorable terms of payment.
5. In special cases, such as in the fur trade, it is necessary to buy large quantities during the season in order to operate.
6. Some concerns operate under contracts which compel them to accept a specified amount of a particular product or merchandise. The oil business is an example of this, as conducted by certain operators.

Although these reasons may lead an enterprise to commit itself heavily in regard to its inventory, nevertheless, a determined effort should be made to keep the inventory in balance. In recent years production and transportation have been accelerated, affecting the size of inventories. There has been a tendency recently to carry smaller inventories because it is possible to get supplies more quickly, thereby making it possible to order small quantities on short notice. Many of the excuses for an over-inventoried condition have therefore been eliminated.

The Small Inventory.—Not long ago a banker called upon the head of a very large mercantile firm to talk over his business problems with him. When the statement of the company was set forth, he looked at the inventory. Considering the volume of business done, there was a very small one: "How can you operate on so small a stock, considering the volume of business you do?" he was asked.

"Well," he replied, "we buy in small quantities, but order very often, and by so doing, we are taking little chance on a change in market prices, but, at the same time, we are able to meet the changing demands of our customers."

One of the advantages which is said to pertain to the small inventory is that it is always possible to jump into the market and take advantage of special bargains. A large paper merchant once remarked that he estimated he saved from $20,000 to $30,000 every year by taking advantage of favorable opportunities to buy what he needed to fulfil his requirements, and that he maintained large bank balances especially for this purpose.

Concerns in the position of most advertising concerns, contractors who carry only supplies in the form of equipment and like companies, hardly have what might be called an inventory. It is no more than to be expected that they would have less to offer in case of liquidation than other types of concerns and,

for this reason, if their ratio of current assets to current liabilities is not consistent with the type of business, they might be considered as more of a risk than another class of concerns which carry large staple inventories that could be turned into cash in the event of financial difficulty.

Questions the Banker Asks.—Before taking up the question of qualitative analysis of inventories it is advantageous to review, here, for the student of finance, some of the questions pertaining to inventories which the banker asks the borrower to answer in writing. A list of queries which are put to borrowers in the statement of Income and Profit and Loss, relating to inventories, used by a certain bank is set forth. Some of the questions it asks are as follows:

1. Regular time of taking inventory.
   a. On what basis taken, cost or market prices?
   b. Is statement based on actual or estimated inventory?
2. By whom taken or made?
3. Date.
4. Regular time of balancing books.
5. Date of taking last trial balance and if same was proved.
6. By whom was statement compiled?
7. Position of person compiling.
8. Amount of fire insurance on merchandise.
9. Average amount of stock carried.
10. Are you fully insured under 80% clause?
11. Do you ship goods on consignment?
12. In what account are such consignments carried?
13. In the case of goods shipped to branch houses, are they carried in your merchandise account or as accounts receivable?

The foregoing questions are appended to the balance sheet, and give the credit department specific information not shown in detail on the customary balance sheet. They should be an-

swered in full by the credit applicant, who should be in a position to supplement these answers with all the financial details the banker may require to analyze the position of the company.

Unfinished Merchandise.—When the banker questions the item of raw materials, it is always essential that a current inventory be presented. Experience reveals that unless the business of the borrower is equipped with accurate methods for cost finding, the items "goods in process," as already noted, are usually difficult to obtain. The bank may send out an investigator to check up as closely as possible. It is just as essential that this item be accurately appraised as finished goods, for otherwise the statement will be incorrect.

Staple Merchandise.—Attention is now directed to the qualitative analysis of inventories with a view to determining comparative values and, by so doing, show how a study of them makes for sounder commercial operations, thereby gaining the banker's confidence.

Inventories might be classified also into staple or unstaple, perishable or imperishable; and from a banking angle the significance attached to the class an inventory falls into is of primary importance.

A staple inventory is one for which, in case of liquidation, a ready market could be easily found. Merchandise such as household utilities, brooms, hardware, and other commodities which are in daily demand, are more readily salable and can be unloaded in much shorter time and, more important still, can be sold to greater advantage than the less staple articles. It is for this reason that bankers look into the merchandise question seriously, to anticipate the character of the borrower's investment in order that, in the event of difficulty, they may be in a position to assist him. It is obvious that banks prefer to loan money to undertakings having their funds invested in staple merchandise.

Unstaple Merchandise.—Unstaple merchandise is of such a character that there is only a limited demand for it. It comprises special classes of merchandise, some kinds of imported goods, and odd varieties of commodities for which because of their limited use, there is no broad market. It is more susceptible to fluctuating market prices and styles and in times of deflation is found more difficult to turn over at a profit than the staple variety of merchandise.

Unstaple merchandise has proved a serious problem in some instances; and this is particularly true during periods following in the wake of a deflation. Following upon the sharp fall in prices during 1920 and 1921, bankers had to take over commodities as collateral security from those concerns which were unable to meet their notes. They undertook to market this collateral comprising special brands of sardines, canned fruits, imported cheeses, carloads of merchandise, all of which were good but for which it was difficult to find an immediate purchaser. In cases like this banks have been known to take months to work off large quantities of goods which had to be dumped on the market at a sacrifice, in order to assist the companies which found themselves financially embarrassed and which had to ask the co-operation of their bankers in liquidating their assets to meet the pressing demands of their creditors.

Perishable Merchandise.—Another angle from which the inventory may be considered, from the banker's and merchant's point of view, is that of whether or not it is perishable. Not long ago a well-known eastern banker visited the heart of the fruit-growing district of Michigan. When he returned he was asked what the most serious problem confronting the fruit raisers was.

The answer was: "Turning over their inventory of fruit at a profit before it is lost to them through depreciation."

Today the loss through depreciation of inventories is little regarded, owing to the fact that there has only been a limited

progress made in the science of conservation, and only the broad margin of profit prevailing in some industries enables the farmers, manufacturers and merchants to carry the load. But with the growing competition in business comes a keener interest in eliminating waste through careless and inefficient operation.

From a banking angle, a highly perishable inventory presents a serious aspect. During the deflation period, when cotton dropped from around 30c to 10c a pound, large producers held their cotton over, rather than sell out at a loss. The resultant effect was to carry over large quantities, which, when ready for marketing a year later, suffered in many cases more than 20% from depreciation.

Bankers have experienced difficulty in many instances in persuading their depositors dealing in perishable foodstuffs, canned goods, and imported specialties, to sell out when the season was in, even at a loss, rather than to hold over for a speculative rise in the market. The law of averages has pointed out the wisdom on the part of bankers in advising such a course of action. And this is especially true in a declining market, where to procrastinate means to take an increasing loss.

Contractual Inventories.—A most interesting form of inventory, and one which is often not even entered on the financial statement, is what might be called a contractual inventory. If a concern has contracted for a large quantity of merchandise, even if the same has not been delivered, it must be considered as a part of the firm's merchandise if the title has passed, inasmuch as the concern ordering it has a responsibility to the manufacturer under the contract.

Imagine the consternation of the bankers, during the deflation, when they learned of the commitments of their customers, many of whom had contracted for large quantities of goods, long in advance. And in the meantime the bottom had dropped out of the market. Were it not for the liberal relations existing

in some instances, permitting the cancellation of many contracts, far many more failures would have resulted than actually did.

Concerns which carry little inventory, due to contractual relations with a factory connection, while they have the advantage of not having to worry about any sizable inventory, still have also the disadvantage, if it may be spoken of as such, of not having the monetary value represented by an inventory in the financial statement presented to their bank.

There are numerous instances of companies which have built up a considerable business through connections which contract to manufacture and ship, at will, commodities at the order of the purchaser. Often such concerns buy commodities finished, and frequently do not order shipment from the factory until their sales organization has sold the merchandise in advance. This is, of course, from many angles an ideal situation; yet it puts the selling organization more or less at the mercy of the manufacturer in the event of changes which might arise in their relationship, or in the production of the commodity.

Comparative Analysis of Inventories.—How can the borrower judge the financial condition of a company through the analysis of the inventory? The answer to this is that at a given season of the year a company will have more or less goods on hand than usual at that time. Experience has shown that if the peak of the inventory period is taken and compared with figures covering, say, 3 or more years, a very accurate picture of the financial condition of the company is revealed.

The comparison of the figures revealing the amount of goods carried will show certain tendencies at specified seasons of the year. If a graph were made of the figures shown in the inventories, it would reflect the depressions, when little goods were carried and the high spots when there was a great de-

mand for more production, consequent heavy inventories, and a rapid turnover of merchandise.

A close study of comparative values, then, will make it possible for a merchant to gauge future requirements more accurately. If there is a careful check made on the type of goods held, it will be possible for him to determine how much to buy of particular commodities to anticipate future requirements and demands.

It has been the experience of many bankers and accountants that merchants who have made a comparative analysis have found that they could do the same amount of business on less inventory and, consequently, could put the cash liberated into more productive channels. An example of this was observed recently, in the case of a large roofing company which reduced its inventories, as a result of making such an analysis, from $300,000 to $100,000, and found that they could do the same amount of business.

Turnover of Inventories.—If the banker or merchant is considering a risk and wishes a true picture of the conditions, he must study the size of the inventory relative to turnover. Investigation occasionally reveals a sufficient inventory on the books to last a company a year, even with a most hopeful outlook for sales. Such a condition is not considered favorable by bankers from a credit standpoint.

Alexander Wall's method of judging the turnover is to take the percentage of sales to merchandise. This relation may be expressed as so many cents for each dollar of sales or, when divided into 360 or 12, as so many days' or months' business on hand. The smaller either figure, the more rapid the turnover of the inventory and consequently the fresher and more salable the merchandise.

In the case of a jewelry store, for example, it may only turn its merchandise twice a year, and still there might not necessarily be any great amount of merchandise which could

be called stale. On the other hand, if we were to take the case of a news stand, if the stock were not turned over in 30 days, there would be an accumulation of worthless periodicals which no one would buy. The banker and the borrower when considering the question of turnover must take the type of business into consideration, and see how it affects the turnover and consequently the merchandise.

Speculative Side to Inventories.—No matter what be the size or character of an inventory, there will always be an element of speculation creeping in owing to the inevitable operation of the law of supply and demand.

One morning a banker walked into the office of one of the largest lumber companies in the South.

"How is business?" he asked.

"Fine," came the reply. "We are $100,000 to the good in the last three weeks."

"How is that?" the banker inquired.

"Well," he continued, "lumber prices are now on the upgrade, and with thousands of feet on hand, we have a paper profit amounting to $100,000."

Out of credit to the merchant it can be said that he still had his inventory listed at cost instead of market, which was the conservative and proper thing to do, since the cost valuation was the lower.

Hedging to Avoid Speculation in Merchandise.—Large seed companies and other seasonal businesses, in order to avoid the speculative risk of carrying large quantities of merchandise, adopt a policy of hedging on the market, to protect their commitments. They buy for an established price for delivery at a future date and, therefore, know just what their inventory is going to cost them.

The advantage of buying in the open market to cover commitments, which necessarily must be made months in advance,

is to eliminate heavy losses due to spotted markets and a possible slump. Indeed, in some lines of business, to do otherwise than to hedge under the conditions which at times exist, would be to hold oneself open to possible heavy losses.

While protection through hedging is deemed wise by bankers where conditions warrant it, at the same time it prevents a merchant from taking advantage of a rising market. But a consistent profit, protected by the hedging operation, works out more to the advantage of the concern that pursues it, in the long run, and makes of it a better banking risk because of the elimination of the element of speculation.

Marketable Securities.—Assets in the form of investments in marketable securities, such as stocks, bonds, short-term notes, liberty bonds, may indicate a speculative tendency in a business, but if they are of the right character and are readily salable, they may strengthen the credit standing of the owner. Whether or not they may be considered as current assets depends upon whether or not they represent actual working capital of an organization temporarily invested but available to meet current liabilities. In the following discussion investments will be divided into two classes:

1. Temporary investments, usually made to secure a return on cash held in excess of present requirements.
2. Permanent investments, usually made to control other companies or to establish sinking or other funds.

Under the first heading we have the example of the well-established firms which find that during certain seasons of the year they have excessive bank balances, and wish to put some of the funds into Liberty bonds or other liquid securities for a short period of time. This is usually only for 90 days, possibly 6 months in some instances, but not ordinarily, depending upon the type of business activity. By doing this the firm gets the additional interest on the money and at the same time is in

a position to put the money in the securities back into the business when the need arises.

The second class represents stocks and bonds often of affiliated or subsidiary companies and is naturally not favored so much in passing upon an application as are those of independent concerns. A further classification may be of interest to the borrower and is as follows:

1. Investments in stocks and bonds of parent companies.
2. Investments in stocks and bonds of subsidiary companies.
3. Investments in stocks and bonds of allied companies.
4. Investments in stocks and bonds of outside companies.

After the banker has scrutinized the securities appearing on the balance sheet the following questions arise:

1. What is the basis of valuation? They should be listed at cost or market, whichever is the lower. The market value should be the realizable selling value at the balance sheet date, and with the market quotation, or based upon individual transfers of the securities made at that time.
2. Are they stocks or bonds? If bonds, the banker wants to know whether bought at a discount or premium, since the true yield often differs from the nominal yield. That is, a 6% bond bought at 95 will yield more than the same bond at 100.
3. Are the securities registered in the name of the concern, if stocks? The banker wants to establish the ownership at once.
4. Are the investments pledged or unpledged? If the securities are in any way tied up, they cannot be depended upon to assist in paying current liabilities, ultimately, when turned into cash. If they are pledged, mention should be made in the balance sheet.
5. If there is a par value, has it been stated in the balance sheet?

The foregoing questions tabulated are only a few which

the commercial borrower who wishes to include securities in his current assets should answer for the banker. From these and many other considerations, which space will not permit here, the credit department of the bank will appraise the value of the investments.

Unissued Stocks and Bonds.—Unissued stocks and bonds are not temporary investments. Accountants hold that, under no circumstances, should they be considered as marketable investments or indeed as investments on the asset side of the balance sheet. They should be shown as deductions from the authorized issue on the credit side of the balance sheet, where they properly belong.

Treasury Stock or Bonds.—It is possible in some instances to include treasury stock or bonds as current assets, although this is not usually the case. There are circumstances which sometimes warrant it, and they may appear in different sections of the balance sheet as follows:

1. As marketable securities among current assets.
2. As investments in the investment section.
3. As deductions from capital stock or bond accounts, on the credit side of the balance sheet.

It is generally agreed among accountants that the borrower or merchant listing treasury stocks or bonds should state them in accordance with accepted practices, depending upon the circumstances prevailing upon each occasion.

Sometimes a company will go into the market to invest its surplus; it may have company bonds covering additions or betterments which have been duly authenticated and turned over to the company, having a known market value; again, it may buy securities to hold temporarily, in anticipation of meeting sinking fund requirements. In any case, the concern should list the securities at cost or market, whichever is the lower.

Accrued Income on Temporary Investments.—It is considered acceptable to include accrued income on temporary investments in the current assets, only if the stock, etc., was owned when the books were closed. In this case the accrued interest on temporary stocks, bonds, mortgages, and notes may be set up and will be acceptable to the loaning banker when passing on the statement application for credit.

Accrued Income on Permanent Investments.—The accrued income on permanent investments when invested in sinking fund securities or in sundry securities, or for other funds invested in affiliated companies, may also be set up as current assets, inasmuch as it is available with other funds to pay out in liquidation of current liabilities.

Prepaid Expenses As Current Assets.—The first question the banker asks when examining the financial statement of an enterprise which lists prepaid expenses among current assets: Do the expenses which are tabulated actually represent working capital? If they do, then the statement is correct. If they do not, then the statement is incorrect.

The practice of including prepaid expenses among current assets is steadily increasing in popularity with bankers and accountants, who believe that inasmuch as such expenditures accrue to the operations of subsequent periods, they should be included as current. It would seem that this is logical, but it is ordinarily true only of a going concern, since such expenditures as licenses or prepaid rentals would be of little immediate value.

In the following paragraph there are listed a number of the more common prepaid expense items, but they will be only commented on briefly:

1. Prepaid interest on notes payable.
2. Prepaid insurance.
3. Current taxes paid in advance.

4. License paid in advance.
5. Royalties paid in advance.
6. Rentals paid in advance.
7. Advanced traveling expenses.
8. Expenses of selling next season's goods.
9. Advertising paid in advance.

After scrutinizing the foregoing items the conservative banker, before accepting them as current assets, will ask of the borrower: "Are these items representative of funds wisely spent, or unwisely spent?" If the assets will ultimately be realized in cash, then the banker will be satisfied to include them as current. But if the expenditures represent money which has "flowed over the dam" never to return, funds which have been injudiciously spent, and which will not be available in the following periods to assist in liquidating current liabilities, then they must be excluded from the current assets.

By way of illustration there is shown on page 429 the statement of a commission sole leather company rejected by a bank's discount committee because of the heavy cash advances on leather and hides shown. It was the opinion of the committee that the advances were too heavy to be consistently safe.

CHAPTER IX

DETERMINING THE POSITION OF "FIXED" ASSETS

Importance of Fixed Assets to a Business.—So far in the discussion attention has been primarily directed to the current assets, and stress has been laid on the importance of correct valuation and acceptable presentation to the banker. Attention is now turned to the permanent or "fixed" assets. Non-current in character, they are so identified with an undertaking as a capital investment, so essential to the profitable operation of a business, that they cannot be entirely dispensed with without destroying the enterprise. Including all property of a permanent character, consisting of land, the buildings thereon, and the machinery, furniture, fixtures and other equipment, they are a potent factor in the balance sheet. They also include any permanent investments, such as working capital loaned to an affiliated company, the stocks of another company bought for the purpose of control, and sinking fund investments which are held for a specific purpose. Patent rights, copyrights, trademarks, goodwill and franchises, and like intangibles must also be included.

To use the foregoing fixed assets to the best advantage, commercially, their value must be determined accurately, and this is especially true when presented in the balance sheet for an unsecured loan or for the issuance of securities.

War-time expansion, with consequent investments in land, buildings, machinery, and equipment absorbed tremendous financial resources in sound, permanent, but slow assets. Curtailed business activities then bringing a period of readjustment impaired the necessary precise balance between liquid and

fixed assets. Thus moneys previously available for payroll and operating expenses, in many instances, became merged with non-current assets, and bankers found their clients handicapped by a dearth of working capital. In many cases, too, where manufacturing concerns had over-expanded, some of the plants had to be sold to make possible the liquidation of bank loans.

Obviously bankers and executives, as they grow rich in experience, realize that in no phase of present business conduct can the value of physical and intangible assets be lightly passed over, or left to guess or conjecture. The commercial borrower and his banker found to their sorrow when they tried to liquidate bank indebtedness that the annual statement has a hollow foundation if its estimate of the assets of a concern is based upon an accountant's guess—a guess that has no better foundation than an estimate of costs at some past period from which certain arbitrary percentages have been "written off" each year.

In many, perhaps the majority of cases of expansion, the dollar was converted into plant property; i.e., buildings, building appurtenances, machinery and equipment. Too often it was abandoned there, or merely recorded as a plant asset at its original cost without thought of depreciation.

What would one think of the investor who put his money in a standard security and failed to watch its appreciation or decline—who neglected to follow its growth through the accretion of interest, extra dividends and market movements? Yet countless executives seek bank credit, and while having great insight into most phases of their business, yet are like a mariner in a fog without a compass, because they are in ignorance of the very foundation of it all—their *actual worth.*

The property dollar, invested in plant assets, grows, declines and fluctuates as much or more than the cash or security dollar. Concerns whose books showed a property value of $100,000 have been astounded with a belated realization that the cost to replace would be nearer $200,000. Yet they were

insured at the old figure. Again, there were concerns which placed plants on their balance sheets out of all proportion to their true worth and, when forced to liquidate, found that through depreciation, obsolescence, and other causes, their original investment had become diminished by more than 50% of its presumed value.

Again, manufacturing or merchandising costs were figured too high or too low because the real worth—the present value—of physical assets, including the plant or store itself, together with its tools and equipment, was unknown. Such conditions have now stirred owners, corporation executives, and bankers to an appreciation of the necessity for property appraisal, just as surely as they know the need for audits of their general accounts for sound procedure.

Characteristics and Classification of Fixed Assets.—Some of the distinguishing features which differentiate fixed from current assets are as follows:

1. At the date of the balance sheet they have a long time to run before they mature, and the expectation is that they will be held for a considerable period of time.
2. They are fixed in character because ownership of the investment is necessary, or at least a valuable requisite to output.
3. From the standpoint of efficient operation, they are usually essential, and without them the concern would be unable to carry out its contracts and moral obligations.

Looked at from the viewpoint of the banker, a most convenient and logical classification of fixed assets is into two groups as follows:

1. Tangible—Those assets represented by land, buildings, and equipment, the latter consisting of such items as machinery, tools, automobiles, horses, wagons, furniture and fixtures.
2. Intangible—These are represented by goodwill, patents, franchises, copyrights, trade-marks.

With this division of permanent assets it will now be attempted to analyze the different classes, with a view to answering some of the questions the banker would ask of an applicant for an unsecured loan. To do this it is proposed to outline briefly some of the elementary principles underlying the appraisal of permanent assets, with suggestions on valuations.

Land.—Because of the ease with which real estate becomes inflated, due largely to over-optimism as to the future and, in some instances, to the perpetration of land frauds causing bankers heavy losses, all real estate transactions entered on the balance sheet are scrutinized very carefully by the loaning banker. The following are a few of the more significant and common questions asked of the borrower by the banker:

1. Is the land held in fee simple, i.e., owned outright, or is it held under a leasehold? If a fee, is the title clear?
2. Are there mortgages outstanding against the property? The amount and maturity of these?
3. If the land was purchased, was it bought for cash or for credit? If purchased for credit, what about the obligations in the note or mortgage, and can they be carried by the borrower satisfactorily? Or was the property donated? If so, how is it listed?
4. What about the title to the property? Does the firm or corporation hold the deeds?
5. Have the taxes been paid up to date, or have they been allowed to lapse?
6. Is the property subject or likely to be subject to the right of eminent domain?
7. Has the land used for operating purposes been kept separate from land held for investment purposes?
8. Have land price fluctuations been recorded? They should not be, as this in many cases would indicate the taking of paper profits. Not until the land is actually sold should they appear. Then the banker and his clients know that they actually exist and are not fictitious.

In taking into consideration the above questions the banker is also influenced by such considerations as these: How well is the real estate adapted to the purpose for which it is being used? Is it accessible to transportation, water, and labor supply?

Moreover, the banker has to take into consideration the type of enterprise when appraising the real estate in its relationship to commercial credit. Land for one type of company might be considered a current asset, from the viewpoint of another a fixed asset. Thus factory land is a fixed asset for a manufacturing concern, but for a real estate company, which is rapidly turning its holdings, it would be considered a current asset. Thus, too, a machine might be considered a current asset to a machinery manufacturing company, whereas for most forms of enterprise a machine would be considered a fixed asset.

Each fixed asset account, with the exception of land, should be offset by a valuation account representing either depreciation or amortization to date. Land should be valued at the acquisition cost to a going business. The banker always wants to know if any intangible profit due to a presumed appreciation has been recorded in the balance sheet. If so, it has no rightful place upon the statement. In order to know properly and present to the banker a complete list of land holdings at correct valuations, an inventory should be taken once each year, and all costs for improvements, grading, etc., should be included in the debit side of the land account as shown in the illustrative land account content suggested as follows:

Debit elements:

1. Deed of sale cost.
2. Acquisition expenses—legal and recording fees, title, insurance, etc.
3. Improvement costs—surveys, tracings, grading, excavating, paving, sewers, underground piping, curbs, wells, planting trees, etc.

4. Carrying charges until either land becomes productive or buildings are erected thereon—taxes, assessments, interest on mortgage, and so on. (Particularly is this true in case of real estate companies.)

Credit elements:

1. Cost to date of land sold. Profit or loss on sale represents a surplus adjustment and it should be thus handled.
2. Decreased appraisal valuation, based upon reports of competent appraisers, representing a surplus adjustment.[1]

The foregoing is an accepted method of handling the land account, and if followed by the borrower will make it possible to present the history of his land holdings to his banker with accuracy and precision. The land account should be debited with all acquisitions and should be credited when land is disposed of—but only at cost. Thus any profit or loss due to a sale of land represents an adjustment of either the surplus or surplus adjustment account. Land improvements are additional charges to the land account as pointed out above.

Often a corporation's book accounts fail to reflect true values, important items being overlooked by accountants or charged off as expense, when they really enhance the value of land, plant and equipment. The prudent merchant and the conservative banker alike feel more assured when an unbiased appraisal is the foundation for the assets listed. Bankers have found from experience that loans based upon the certified appraisal valuations of land, buildings, machinery and equipment are apt to be more amply safeguarded, and for that reason recommend that certified appraisals be made wherever possible. Indeed, it is the custom of investment bankers in purchasing issues to obtain reports by appraisal companies of recognized

[1] George E. Bennett, Basic Accounting, p. 286.

standing regarding the value of the borrower's physical properties.

Property Accounts.—Buildings should be recorded in the balance sheet at their cost to a going concern, this taking into consideration all expenses necessary to place the buildings in condition for operating purposes. The cost of buildings includes appurtenances thereto, unless separate accounts are carried. Appurtenances include electric wiring, electric and gas fixtures, heating apparatus, plumbing, etc., and should if possible be properly appraised by an impartial appraisal company.

When analyzing a statement a banker is at times doubtful of an item of valuation on buildings, and the borrower must be prepared with vouchers, bills, and papers constituting the full evidence to substantiate his claims. To be prepared for such contingencies the borrower will find that a carefully kept property account will prove invaluable for reference in matters of loans, tax matters, insurance, and computing costs of operation in appropriation of overhead.

Properly functioning, a comprehensive plant account shows many details of property worth, chief among which may be mentioned:

1. Cost.
2. Deterioration (deductions for depreciation in all phases).
3. Improvement (expenditures for betterments).
4. Relation (co-ordination of units by departments).
5. Values
   (a) Reproductive, depreciated, insurable net sound.
   (b) Retrospective: e.g., as of March 1st 1913, for Federal tax purposes.

This information—all of it—should be readily and immediately accessible to insure the highest consideration from the banker and maintain proper efficiency. Too many great organizations, apparently prosperous and smoothly functioning in

every way, cannot supply the substance of this knowledge from their existing records.

It is the experience of accredited appraisal firms that in making their valuations corporations often wholly overlook important items which make the true values much higher than those often prepared by the accountant or treasurer of the company. Thus, independent of the matter of figuring overhead for purposes of arriving at costs and selling prices, and apart from any proposed merger or sale, your accounting department should know, exactly, both the reproductive and actual net worth of the property; otherwise its monthly and annual statements upon which are based actions, loans and policies, are apt to be gravely misleading.

It has been claimed by some authorities that a plant's valuation should be influenced by its indispensability to the profitable conduct of the business. Hence land, buildings and equipment, which might bring little under a forced sale, would be valued at a much higher figure when owned and managed by a capable borrower.

Some of the more significant questions which arise in the banker's mind when analyzing the plant item in the balance sheet are as follows:

1. How does the valuation presented by the borrower in the statement check with the county assessment figures?
2. How do the valuations check with the market value?
3. Have improvements been capitalized by the borrower? Additions may, but improvements may not and should not be included in the valuations.
4. Has an attempt been made to adjust values to the market without a definite appraisal by an accepted appraisal company of standing? If such a revaluation has been attempted, is the borrower trying to cash in on anticipated paper profits? All profit and loss due to reappraisal should be separated from the change resulting from operations.

5. How does the physical plant value given by the borrower show up when reckoned in the light of location, transportation facilities, labor supply, operating efficiency and adaptability?
6. What would an expert in the line give for the plant if taken over as a going concern? Very often the special character of the plant makes it adaptable for no other line of business than the previous one, and hence it will bring only what another firm in the industry will give for it.
7. What is the policy of the firm as to providing for depreciation?

With the assistance of certified public accountants and of a well-rated appraisal company the answers to the above questions will be approximated by the commercial borrower, so that he will know exactly where he stands when he presents his statement to his banker.

Depreciation.—Buildings lessen in value year by year due to wear, tear, and the action of the elements, and provision must be made for this reduction in value. This is done preferably by means of a valuation account, the use of which preserves the original cost value upon the records and the shrinkage in that value in a separate account. This account is usually handled similarly to those of accounts receivable; and an illustrative set-up of this account correctly should be:[2]

Buildings (original cost) .....$ —
Less: reserve for depreciation..... —

According to different authorities, rates of depreciation ranging from 1% to 5% constitute a fair average. The nature of the structure, location, kind of occupation, etc., are factors which must all be taken into consideration. Briefly summarized, in securing workable rates, consideration is given to the five cardinal factors herewith enumerated:

[2] George E. Bennett, Basic Accounting, p. 290.

1. Depreciation from wear and tear.
2. Depreciation due to deferred maintenance (neglected repairs).
3. Depreciation from age.
4. Depreciation due to inadequacy.
5. Depreciation due to obsolescence.

All these influences must be considered in determining the life of physical assets, the accrued depreciation accurately ascertained, and the annual rate fixed.

Naturally, different units, under varying conditions, require divergent selective rates of depreciation and it is impossible to ascertain the correct rate except by segregation. When handled in a first rate certified appraisal, this method will do much to protect the borrower from the shiftless "hit-or-miss" policy of charging sums for depreciation purposes only when the earnings are large, and omitting to do so entirely when earnings are small. Such a procedure deserves the condemnation of every practical man and creates an impression of heedlessness on the part of the banker from whom credit is asked.

Equipment.—Under this heading the applicant includes all items either within the walls of a building or attached to it in some way. In general, equipment may be divided into two classes: (1) Building appurtenances: ventilators, fine apparatus, elevators. (2) Operating equipment: machinery, belting, furniture, etc.

When examining the appraisal of the equipment entered in the statement, the banker wants to know the circumstances surrounding the origin and condition of the items. Among the more obvious questions which arise are:

1. How acquired? If newly acquired, was the equipment constructed within the organization or without?
2. Purpose of acquisition?
3. What may happen to the equipment? How will it wear? Is it susceptible to fire, depletion, etc.?

4. Disposition eventually? Will it be possible to sell the equipment in whole or in part, or in the case of emergency will it have to be sold as junk?

In studying the foregoing items the banker takes into serious consideration the elements of unusual risks due to fires, floods, and the like.

Machinery.—Machinery includes such items as lathes, drill presses, grinders, machine tools, line shafting, and belting pulleys. The conservative manufacturer sets up a proper and liberal depreciation for each machine separately, and so arranges his amortization fund that when the machine is worn out the reserve will be in the bank to enable the purchase of a new one. Bankers find from experience that machines sold at auction under the hammer bring only 30% of their original value, even if in good condition, sometimes more, sometimes less, depending upon the varying conditions. Thus in a statement machines do not prove a very heavy item for the commercial borrower to lean on in asking for credit.

Tools.—Tools are of such a character that they depreciate rapidly. The banker encourages the merchant or manufacturer to set up a proper reserve and to take a yearly inventory to see that there is a proper check on the number and quality. They are of little assistance to the borrower in applying for a loan, because of their unliquid character and the wear and tear they are subject to, so that they are soon either worn out or obsolete and of little cash value, except for junk in case of liquidation.

Financial Value of a Certified Appraisal.—As was outlined in the introduction to this chapter, bankers in making bank loans are coming more and more to realize the value of an unbiased certified appraisal by a firm of standing. They recommend appraisers to their depositors for their own good. The business sagacity and sense of fairness that prompts a prospective borrower in providing a certified appraisal, in turn,

creates a favorable impression with any modern banker and enhances the stability of the "moral" risk in his eyes. As summarized by an appraising company, these are some of the advantages of a certified appraisal:

1. It is an authoritative record of actual values based on actual cost to reproduce at the time the appraisal is made, less actual depreciation; not an arbitrary "charging off" by percentages.

2. It protects your insurance by providing a correct basis of valuation, assuring that all losses will be paid in full when fire, tornado, boiler explosion, or other insurable catastrophe overtakes you.

3. It forms a safe and sure basis for placing fire insurance when specially insured under separate items and probably at different rates.

4. It is equally as effective in preventing under-insurance as over-insurance, and is a basis for compliance with co-insurance requirements. It tells you what your property is worth, not alone for insurance purposes but as a safe and accurate basis for figuring manufacturing costs, overhead charges, depreciation and appreciation of plant equipment.

5. It furnishes authoritative foundation on which to determine bond issues, stock issues, dividends, partnership divisions, and settlements.

6. It is of assistance in presenting a statement to the banker when asking for a loan or for a line of credit.

7. It inspires confidence both in present and prospective buyers of your securities, or creditors on the unsecured basis. It supplies authentic, impartial and authoritative data upon which to conduct the purchase, sale, partition, bonding or merging of properties.

8. It is as necessary as fire insurance, for large undertakings especially, because it is necessary to secure a speedy adjustment of insurance; yet its other and broader functions assist the borrower in the wise conduct of business, and make for wholesome progress.[3]

From their summary of a few of the chief advantages of a certified appraisal, it can be seen that it renders worthwhile assistance to officials, accountants and plant managers, inspires confidence in the management, and makes it possible to place actual plant conditions before the directors and stockholders.

A good certified appraisal need never become obsolete. Price

[3] Coats & Burchard Company, "What Is A Certified Appraisal, and What Value Has It to You?"

fluctuations, depreciations and physical property changes are covered by an annual revision service which can be arranged for when an appraisal is made. All changing factors are given proper weight in bringing records up-to-date and when the merchant-borrower presents his statement to the banker, he is

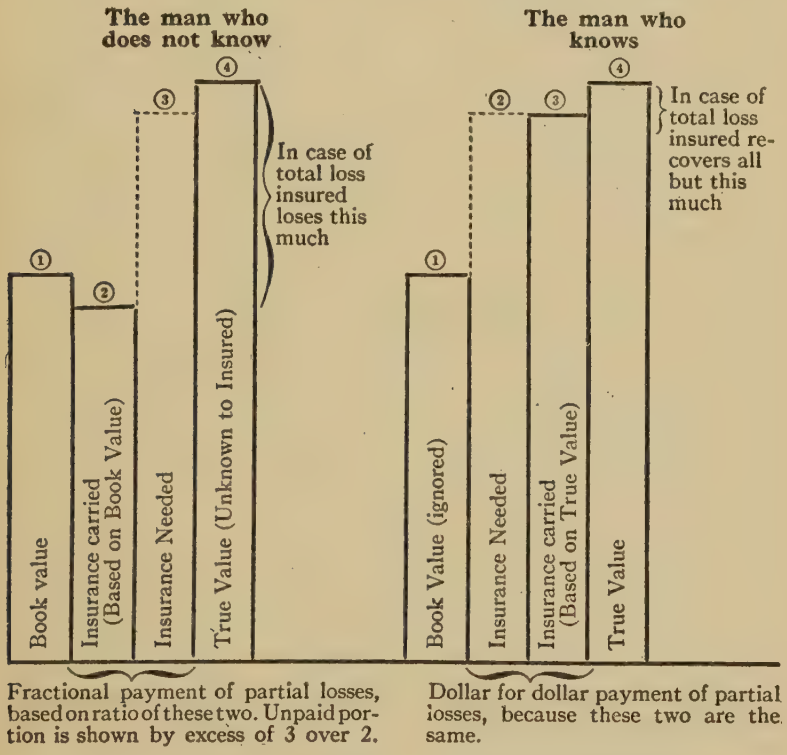
The man who does not know
The man who knows
In case of total loss insured loses this much
In case of total loss insured recovers all but this much
Book value
Insurance carried (Based on Book Value)
Insurance Needed
True Value (Unknown to Insured)
Book Value (ignored)
Insurance Needed
Insurance carried (Based on True Value)
True Value
Fractional payment of partial losses, based on ratio of these two. Unpaid portion is shown by excess of 3 over 2.
Dollar for dollar payment of partial losses, because these two are the same.

Figure 12. Diagram Showing Possible Saving in Insurance
(By Coats & Burchard Company)

doing so with the assurance of sound valuations. As an illustration of how facts presented in a certified appraisal may be worth many times what it costs to get them, in the diagram shown in Figure 12 there is represented the possible saving in insurance which comes from an accurate knowledge of values.

In many standard policies there is inserted a co-insurance clause which in substance generally reads as follows:

"This company shall not be liable for a greater proportion of any loss or damage to property described herein than the sum hereby bears to . . . . per centum of the actual cash value of said property at the time such loss shall happen."

The commercial borrower who is trying to protect himself and his banker must bear in mind that the insured receives the full amount of any loss, up to the face of the policy, provided he meets the requirements as to the percentage of insurance—but woe to the man who assumes that "book value" and "actual cash value" are synonymous. The rewards and penalties of co-insurance are clearly shown by the diagram in Figure 12, and from it the reader can see the advantage of knowing positively the values placed on tangible property.

"The man who knows" carries insurance based on the size of Bar No. 4, which was known to him in advance. Because values were known, Bar No. 2 and Bar No. 3 are the same. The insurance adjuster recognizes this fact and, as a result, he makes a full settlement of any loss, up to the face value of the policy.

"The man who did not know" based his insurance on the size of Bar No. 1, or book value. The amount of insurance he should have had was unknown to him. When a loss occurs, the insurance adjuster will disregard Bar No. 1. He proceeds to determine the size of Bar No. 4; from this he calculates Bar No. 3; and the amount of insurance paid is based on the direct ratio of No. 2 and No. 3.

To state this point in another way, "the man who does not know" does not merely stand a chance of losing 10% in case of a total loss under a 90% contract—he may lose, even on a partial loss, 30%, 40% or 60%—or any per cent proved by the extent of the difference between Bar No. 2 and Bar No. 3.

The foregoing considerations are of vital importance to the banker, because under adverse conditions, borrowers who

are not conversant with actual conditions and valuations, find themselves so severely handicapped financially that they are unable to meet their obligations at the bank.

The Intangible Assets.—Among the more important intangibles appearing on statements are goodwill, patents, trademarks, franchises, and other items including copyrights. Of these the assets of most frequent occurrence are goodwill and patents. Sometimes goodwill is shown as one of the fixed assets, but it is accepted good practice in accounting to show it under a separate heading. Bankers are generally of the opinion that it is difficult to put an accurate valuation on such intangibles as goodwill and patents, and the conservative policy is to list them both separately.

But because these assets are intangible is no reason why a banker or merchant should use hasty judgment in concluding that they are worthless. If it is true that credit men may view with suspicion a statement which apparently puts too much emphasis on its intangibles, still the intangibles have a legitimate use and value and in some instances constitute the most valuable portion of the assets listed on the financial statement.

Goodwill.—The comparative statement of a dairy machinery manufacturing company, given on page 465, shows goodwill, patents, patterns, etc., listed for 3 years at better than $2,000,000. Indeed, in 1926 the company set up the figure $2,404,140, an increase over the previous year. Generally credit men and bankers are of the opinion that these items should be listed ordinarily at a nominal figure, and be charged off as much as possible. The impropriety of stressing goodwill on the balance sheet, unless paid for by purchase or otherwise, is established and rests upon sound business principles. Thus, when the banker views a statement with a large figure for these items, he probes into them and tries to sound out an authentic foundation upon which they must rest if they are to

be given an appreciable amount of consideration in granting accommodation. Obviously a company like Coca Cola or Palmolive, would have an item of goodwill which years of advertising has established, and which might be said to rest on realizable values. On the other hand, a young concern which has spent little on advertising, has a small business, and some doubtful though promising patents or goodwill, is not justified in setting up these intangibles at more than a nominal value; and often it is conservative practice to put the sum of one dollar down, and by so doing show the banker that while there was claimed some goodwill, yet there is obviously no attempt to cash in on a problematical valuation.

Goodwill has been defined as the "value of a business name, of a reputation, of a locality, or of patronage." [4] Merchants, bankers, and other lines of business activity are proud of their goodwill. Not long ago a merchant entered a bank and laid a report before his banker which was a complete summary of just what his customers thought of his company and product. On each card was a percentage which was an indicative rating the customers were asked to fill in in answering the inquiry. The goodwill set forth in this report by the customers was close to 100%; and while it might have been difficult to appraise the correct value of the goodwill, still, to the banker and the merchant alike, it was without doubt highly indicative of the excellency of the product and of the sound merchandising policies which by national advertising had built up a valuable paint business.

In summing up the foregoing, it is well to add that the item of goodwill is not needed for a prosperous-looking balance sheet, and while it may be booked at what has been paid for it, the fact that goodwill has frequently been found by bankers to have no value when it is most needed, prompts conservative managers to write it off against the surplus account when there

[4] Geo. E. Bennett, Basic Accounting, p. 295.

are profits, and under normal conditions to reduce this item to a nominal amount, or to zero, regardless of what it cost, as soon as possible.

Patents.—Patents are another intangible asset and may be recorded on the balance sheet at cost for a going business. It includes such items as experimental expenses, patent attorney's fees, cost of drawings, registration fees, and like expenses. Because the patent right is limited by the government to 17 years, it is customary to amortize the patent account over that period of years. Because of the possibility of encroachment, possible lawsuits, lapse of time, supersession and obsolescence, bankers are loath to allow over-much weight to this item in the statement. Consequently, in presenting the item the merchant or manufacturer should always be open to investigation and his records covering amounts set up for patents should always admit of verification.

Trade-marks.—Like patents, trade-marks have a value of which it is hard to form an accurate opinion, and bankers are naturally suspicious if too large an item covering this intangible is present in a statement. What did the trade-marks cost to develop? What will they cost to purchase, and what will they cost to defend? These are some of the questions the banker wants answered when appraising this item. While the intangible items contribute often substantially to the success of an enterprise, still, the dictates of conservative policies point toward recording them on the balance sheet at nominal figures.

Franchises.—Often a quasi-public institution, such as a utility company, has franchises representing substantial amounts entered on the statement under intangible assets. They are associated with rate-making agreements, rather than with ordinary use; and the banker in examining them wants to know, among other things, the following:

1. Were the franchises paid for in lump sum?
2. Were they paid for in full price to another corporation?
3. What were the legal fees, etc., in procuring them?
4. What was the cost, or what will be the cost, of getting the property owners' consent?

The terms of the franchise, the duration, expense, and estimated revenue expected which will take care of the terms of the franchise, are all important considerations, depending upon the kind of franchises, and the circumstances surrounding them. Bankers ordinarily would classify this item on much the same basis as a lease and the borrower would do well to have an accurate certified appraisal made, inasmuch as it is an item which would take considerable analysis and study upon the part of a banker to form a basis for judgment. They get, in general, much the same consideration from the banker as the other intangibles and should be entered under a separate heading and if necessary, should be explained in the footnote of the balance sheet, that the banker may readily see just what the item includes.

Fixed Asset Ratios.—How much should ordinarily be represented on the balance sheet in fixed assets? What are some of the factors that determine the amount invested in the permanent assets of an enterprise? Bankers and expert certified accountants who have had long experience in statement analysis are of the opinion that under normal conditions there should be an ample margin of net worth and funded debt over and above the plant investment. This provides that the owners of the business should furnish a reasonable proportion of the active working capital of the business. This ratio is significant, for it reveals the adequacy of the capital and shows the extent to which the capital is tied up in plant.

The factors which determine the amount invested in the plant assets are many and among the more common are:

1. The amount will naturally be more heavy for the manufacturer than for the merchant.
2. The elaborateness of the manufacturing process will influence the amount of capital necessary to sink in this item.
3. The length of time it takes to produce the commodity or commodities.
4. The cost factors in purchasing plant equipment will depend on the process of production, and other allied considerations.

Ordinarily in periods of rising prices, when the plant relationship to net worth shows an increasing plant investment, it may indicate a dangerous condition. This is particularly true when the investment in plant assets is made in a period of high building costs, as during the recent inflation just preceding 1920. During that period large candy and other manufacturing concerns built enormous factories to supply an abnormal demand caused by the war and post-war inflation. When the day of reckoning came, many concerns found that their plant investment was out of all proportion to their net worth, and they were "plant poor." This led to a period of "tied-up capital," which many companies were unable to survive.

Plant Assets in Relation to Sales.—Another test which may be applied to the fixed asset investment is to use the item of sales as a yardstick. What is the ratio of dollar sales to each dollar of plant? The answer will tell the borrower whether the volume of business he is doing is commensurate with the size of the plant. The all important question the banker and the borrower should know is: Does the plant contribute the proper amount of earning power to the concern?

When the student of finance finds that the relation between net worth and fixed assets, and the relation between sales and fixed assets are low or falling, the plant is increasing more than is the net worth. What does this indicate?

The answer is, that funds are being invested more rapidly in fixed assets than they are being created. Thus we have a conversion of liquid capital into fixed capital which often proves a forerunner of financial difficulty.

In judging the fixed assets the banker never overlooks price factors. He realizes that in the past decade plant and equipment costs have changed. In many instances replacement values have more than doubled, so that were a concern to replace its original investment it would take 2 dollars of investment now where formerly it had taken but one. Thus while bearing in mind accurate valuations, the banker weighs carefully the relation between the fixed assets, on the one hand and the quick assets on the other, to see that there is a reasonable proportion of active working capital consistent with the character of the enterprise and its requirements. In judging, therefore, a concern's progress the banker differentiates between the one which is merely accumulating a heavy investment in plant and other fixed investments, and the one which is actually making progress through maintaining a happy equilibrium between the different elements of its financial structure.

CHAPTER X

ANALYZING THE CURRENT LIABILITIES

Proprietorship as Related to Liabilities.—Many of the fundamentals discussed in connection with assets may be applied with considerable advantage in the study, presentation and analysis of the current liabilities to which attention will be directed in this chapter.

If a study is made of a company's balance sheet, it is apparent that there are two ownerships involved. The first is evidenced by the money advanced by the owners, and the second by the funds furnished by those outside; and because the ratio of current liabilities to net worth of an enterprise is a strong indication, not only of the financial status of a concern, but of the amount of the proprietorship of the owners in the business, the banker often looks first for the liabilities and then for the current assets with which to liquidate them.

It is an accepted banking policy, as James B. Forgan, former President of the First National Bank of Chicago, once remarked, that "no one should be granted credit by a bank without security who cannot, in addition to his real estate, plant and other fixed property, show readily convertible assets in the shape of merchandise and accounts and bills receivable of sufficient value to afford a reasonable and proportionate margin in excess of his liabilities." This margin of surplus quick assets, whatever it may be made up of, represents the proprietorship, in liquid form, invested in the owner. Thus, when the lender examines a statement, he is apt to look first, as suggested above, at what the borrower owes and then for the current assets with which the liabilities are to be paid. When

the ratio of current liabilities to net worth is abnormally high, it indicates a proprietorship limited by an undue amount of outside capital invested in the business and the industry must consequently rely to greater extent on the economic capital and goodwill of its creditors. With normal liabilities and satisfactory earnings, the balance is maintained and with little fear of the creditors taking over the business, the banker, upon the completion of a thorough investigation which measures up to his requirements, extends such credit as is needed for the current operation of the enterprise.

When examining the current liabilities the banker is always on the defensive. Because commitments once made are often impossible of cancellation, his caution is fully aroused when appraising the borrower's liabilities. The possibility of existing hidden liabilities, buried obligations which take penetrating analysis and synthesis to disclose, are ever uppermost in his mind. Things that register upon the loan official's mind, when studying a statement to find possible irregularities in the liabilities column, are not passed over lightly, even though some of them at first blush seem to have but slight significance.

Importance of Complete Information on Liabilities.— Under certain circumstances a failure to diagnose properly the liabilities in a financial statement may represent only a professional error on the part of the banker and an unintentional blunder on the part of the borrower. Yet conditions may be such that there may be incurred a heavy liability for the bank through misguided financial assistance. It is for this reason a conservative banker will refuse to pass on a statement until every means have been exhausted of verifying the accuracy of the borrower's statement of his liabilities.

With the above considerations in mind the loan official tries to ascertain, in discussing a statement with a borrower, among other things, the following: (1) What check may be made outside the statement which will place the values set

forth, and assist in disclosing possible hidden liabilities? (2) What possibility exists for the liability entries being in error?

It can be seen from this that the borrower must exercise the utmost care and human foresight in presenting his current liabilities before his banker in their entirety, and so clearly as to be readily understood.

Fallibility of Human Nature and Liabilities.—It is questionable whether the time will ever arrive short of the millennium, when a man can be depended upon to prepare an absolutely impartial statement of his own financial affairs. The one basic reason is that we are all fallible, the fallibility of human nature being as old as the race.[1] Consequently, the applicant, to avoid listing his liabilities improperly, learns from experience that it is economical in the long run to get his statement verified by an unbiased certified public accountant that his liabilities will, when set up, be a true reflection of his obligations and, therefore, be clear to the banker when analyzing the statement.

By way of illustrating the above, if the reader will observe the two statements in Figures 13 and 14, he will readily see the importance of having his liabilities set up by an accredited certified public accountant. Figure 13 represents the statement of a firm presented by the experienced accountant. It will be noticed that he sets up a statement showing current assets of $264,152 against current liabilities of $219,915. He lists accounts receivable on consigned merchandise on the asset side of the balance sheet. In Figure 14 a well-meaning bookkeeper sets up the figures as of the same date, reducing the current liabilities to $108,335 or about 100% by offsetting the accounts receivable due on consigned merchandise sold against the amount due on consignments. While improving the ratio of current assets to current liabilities, the bookkeeper does not present as truly a representative statement to the banker. The

[1] See Robert H. Montgomery, "The Fallibility of Unverified Financial Statements." Credit Men's Bulletin, Vol. 1, 1913, p. 621.

To the LAKE SHORE TRUST & SAVINGS BANK

Name of Firm.....
Business.....Food Brokers.....
Location.....

For the purpose of obtaining credit, from time to time, with the above bank for our negotiable paper, or otherwise, the undersigned furnishes the following statement of condition as of the....6th day of....January, 1920....; and the undersigned hereby agrees and guarantees that said statement and all other information herein furnished is in all respects true and correct.

ASSETS				LIABILITIES			
Cash on hand and in bank	10	781	62	Notes payable to own banks, secured bank	19	901	00
Cash advances on consigned merchandise	36	586	79	Notes payable to others	25	534	00
Notes receivable of customers, good		176	25	Notes payable for paper sold through brokers, secured			
Accounts receivable on consigned merchandise	112	862	63	Notes payable for paper sold through brokers, unsecured			
Accounts receivable for J. L. & P. merchandise sold	11	912	28	Notes payable for whses. consigned mdse	39	880	00
Merchandise, finished $85,288.54				Notes payable for J. L. & P. mdse. in whses	18	220	00
Merchandise, unfinished $				Trade or bank acceptances			
Raw Material $				Open accounts, not due on consigned mdse. sold	116	380	69
Consigned merchandise $				Open accounts, past due			
Total merchandise $85,288.54				Bank overdrafts			
Less reserves $	85	288	54	Accrued property taxes, interest, etc			
Liberty Loan bonds $				Accounts payable to partners			
Less bank loans on same $				Deposits of money by relatives or employees			
United States Certificates of Indebtedness				Deposits of money by others			
Other stocks and bonds listed on Exchanges, market value				Mortgages or liens on real estate; due during fiscal year			
Other **Quick Assets** and of what composed:				Other current liabilities, and of what composed:			
Accounts Receivable—Brokerage	6	544	38				
Total current assets	264	152	49				
				Total current liabilities	219	915	69
Accounts receivable of customers, doubtful $				Mortgages or liens on real estate, due after fiscal year			
Less reserve				Chattel mortgage notes			
Notes receivable of customers, doubtful $				Other liabilities, and of what composed:			
Less reserve				Capital stock	50	000	00
Notes or Accounts Receivable, owing by Partners	12	174	40				
Stocks and bonds **not listed** on Exchanges, at market value				**Total indebtedness**	269	915	69
Advances to salesmen and other employees				Other reserves and contingent accounts			
Real estate, other than plant				Federal taxes	1	276	58
Plant $				Bad debts		400	00
Less reserve							
Machinery and fixtures $ 2,436.35							
Less reserve 548.39	1	886	96				
Autos, horses, wagons, etc $							
Less reserve							
Goodwill, patents, trade-marks, etc							
Interest, Insurance, etc		796	75	**NET WORTH** (See Page No. 2)	9	418	33
Other assets and of what composed:				**Total liabilities**	281	010	60
Unscribed stock unissued	2	000	00				
Total assets	281	010	60				

Figure 13. Statement Prepared by the Skilled Accountant

To the LAKE SHORE TRUST & SAVINGS BANK

Name of Firm.....
Business.....Food Brokers.....
Location.....

For the purpose of obtaining credit, from time to time, with the above bank for our negotiable paper, or otherwise, the undersigned furnishes the following statement of condition as of the....6th....day of....January,....1920....; and the undersigned hereby agrees and guarantees that said statement and all other information herein furnished is in all respects true and correct.

ASSETS					LIABILITIES				
Cash on hand and in bank		10	781	62	Notes payable to own banks, secured by negotiable whse. receipts		103	535	00
Brokerage rec.		6	545	38	Notes payable to own banks, unsecured				
Notes receivable of customers, good			700	25	Notes payable for paper sold through brokers, secured				
Accounts receivable of customers, good		11	512	28	Notes payable for paper sold through brokers, unsecured				
Trade or bank acceptances					Notes payable for merchandise				
Claims	$		232	76	Advances by customers on purchases				
Merchandise, finished	$	85	288	54	Trade or bank acceptances				
Raw Material	$				Open accounts, due				
Advances on consigned merchandise	$	36	358	72	Bank overdrafts				
Total merchandise	$				Accrued property taxes, interest, etc				
Less reserves	$				Accounts payable to partners				
Liberty Loan bonds	$				Deposits of money by relatives or employees				
Less bank loans on same	$				Deposits of money by others				
United States Certificates of Indebtedness					Mortgages or liens on real estate; due during fiscal year				
Other stocks and bonds listed on Exchanges, market value					Other current liabilities, and of what composed:				
Other Quick Assets and of what composed:					Due on consignments sold	$116,153.62			
					Less accts. rec. consignment sales	112,629.87	3	523	75
Total current assets		155	294	95	**Total current liabilities**		108	335	33
Accounts receivable of customers, doubtful	$				Mortgages or liens on real estate, due after fiscal year				
Less reserve					Chattel mortgage notes				
Notes receivable of customers, doubtful	$				Other liabilities, and of what composed:				
Less reserve					Capital stock	$50,000			
Notes or Accounts Receivable, owing by Partners					Less unissued treasury stock	2,000	40	225	00
Stocks and bonds **not listed** on Exchanges, at market value					Less unpaid sub	$48,000			
Advances to salesmen and other employees					**Total indebtedness**	7,775			
Real estate, other than plant					Bankers' Acceptance discounted		11	492	56
Plant	$								
Less reserve									
Machinery and fixtures	$								
Less reserve		1	886	96					
Autos, horses, wagons, etc	$								
Less reserve									
Goodwill, patents, trade-marks, etc									
Interest, Insurance, etc			796	75					
Other assets and of what composed:									
					NET WORTH (See Page No. 2)		9	418	33
Total assets		157	978	66	**Total liabilities**		157	978	66

Figure 14. Statement Prepared by the Firm

reader can readily see that from the point of view of bank credit the difference in the two statements is important. By arranging the items properly the statement appears with more liabilities and is more clear as presented by the auditor in that the borrower does not set up his consignment business items to offset each other. Further analysis reveals other comparisons which are of interest to the student of finance, but on which space will not permit further comment here.

Questions Asked by Banker.—Before examining in detail each of the current liabilities shown in the statement form just referred to, it is proposed here to list a few of the more common questions the banker asks, and tries to get answered by the borrower when he checks up and goes over the current liabilities listed:

1. Does the balance sheet presented state the whole truth, or only part of the truth, regarding the current liabilities?
2. Are there any hidden notes held by other banks not listed in the statement?
3. Are there any buried obligations for merchandise or other expenses pertaining to the operation of the business?
4. When terms on invoices and contracts are checked up with what appears in the balance sheet in current liabilities, do they gibe?
5. Are all offsetting entries made correctly to show the proper liability of the firm?
6. Are all amounts representing accruals for taxes, wages, rents, commissions, etc., included, or have some been overlooked?
7. When current liabilities are checked against the amount set up in the inventories, do they show a proper relationship? A concern cannot receive title to merchandise without listing the amount of the liability incurred in the statement to offset the increase in the inventory account.

8. Does the firm contemplate buying someone out? Often when a firm is trying to get some member to sell out, it inflates the current liabilities, and when credit is sought, underestimates the current liabilities.
9. Is it possible that the statement and the books may disagree? If it is thought so, the banker will ask for a new statement, if still interested.
10. What is the character of the current liabilities, as contrasted with that of the current assets, regarding their maturity? If current liabilities are small in amount, as compared with current assets, such as accounts or notes receivable, which cannot be collected until some later date, a serious condition might exist, even though a fair ratio of current assets to current liabilities is found.

Notes Payable—Classification.—This is considered by many bankers and accountants as the most important item among the current liabilities and may be divided into five sub-classes:

1. Notes payable to own banks, secured
2. Notes payable to own banks, unsecured
3. Notes payable for paper sold through brokers, secured
4. Notes payable for paper sold through brokers, unsecured
5. Notes payable for merchandise

The above classification is that used by a middle western bank on the statement form it submits to its depositors applying for an unsecured commercial loan. It is noted that there is a space provided in which to list each class separately. The borrower, for his own information and his banker's, should also divide his notes into those not due, those due, and those past due. For the applicant to list past due notes with those not due, without bringing this to the attention of the banker, would leave a very bad impression. For this reason the judicious borrower will list his aged notes separately under "Past Due." The banker then will be in a position to begin his analysis with the assumption that the remaining notes are

fresh, likely to be paid at maturity, and will go ahead with his investigation on that basis.

Notes Payable for Merchandise.—Reversing the order of classification, we will take first for consideration notes payable for merchandise. Among the current liabilities none is more significant, nor a better index to the financial condition of a company than the notes payable for merchandise. These are unpaid promissory notes or drafts not due, given in ordinary course of business for merchandise, materials, supplies, and other commodities used in the conduct of the business. They include also all notes similarly executed and negotiated by branches, agents acting for the manufacturer, merchant, or sales agency. They must be listed separately under the proper headings, as shown in the balance sheet in Figures 13 and 14.

It has been observed above that notes or bills payable for merchandise are legitimate only in certain industries where custom sanctions their use instead of that of open accounts. In many lines of business notes payable for merchandise are suggestive of a shortage of working capital, indicating over-expansion, or under-capitalization. Experience in analyzing notes on the part of bankers and accountants makes it logical to assume that: (1) If notes payable for merchandise appear in the balance sheet, notes payable to banks should not. The merchant should discount his bills with the funds received from the bank. (2) If notes payable for paper sold through note brokers, secured or unsecured, appear, then bank lines are ordinarily kept open. This makes it possible to liquidate the commercial paper obligation by borrowing from the banks direct if so desired.

When the borrower lists notes in his statement, he should be prepared to inform his banker as to the date, creditor, date due, interest rate, amount, interest accrued to date of audit (if discounted), endorser, whether original or renewal, and collateral security put up for the notes, if there is any. This

last information, regarding collateral, is important, as the banker wants to know whether the applicant for a loan is prepared to furnish him collateral for a loan; and if the borrower furnishes collateral to one banker, it is only natural that the other bankers will also want their loans secured.

When Quantity of Notes Is Too Large.—Before going further with an analysis of notes it will be of interest here to illustrate by two cases how a company may have, as a result of slow payments and collections, a large percentage of its obligations payable in the form of notes. The condensed statement on page 459 is that of a wholesale grocery business. It will be noted that its notes payable are $300,000, and that other items payable amount only to about $12,923. For the type of business the item was considered out of proportion. For a farm machinery business the amount tied up in notes would have been more logical, but for a mercantile house it was considered too large when appraised by the banker.

What Increased Notes Payable Indicate.—To cite another example, the statement on page 425 shows how a threshing machine company increased its note obligations for merchandise from $547,001 to over $2,000,000 in 4 years' time. Assuming that it was the policy of the company to do so, why was it necessary? Among other reasons why this condition was brought about are the two following: (1) The company's receipts for the period show a large increase in notes receivable, which indicates that the farmers gave in increasing amounts their notes with long maturity in return for merchandise. (2) The accounts receivable of the company show a decrease for the period of 5 years, which indicates a slowing down in actual cash payments for merchandise sold.

Unquestionably there were other influences which caused this change, but from a banking angle, the important question

was: Did the increase of the notes payable indicate a shortage of working capital? If not why was it not more profitable for the company to discount its bills payable, thereby realizing a considerable saving? The slowing up of accounts receivable may have made such discounting impossible. If a borrower is presenting his statement and such changes appear, the wise thing to do is to explain why the change was necessary, and why it was impossible to discount more bills owing for merchandise, thereby saving the amount of the discount for the company.

Notes Payable for Paper Sold Through Brokers.—All notes in the form of commercial paper sold through brokers should be listed separately; and if secured by collateral, the securities or whatever is put up for security should be shown on the balance sheet.

It is usually wiser and inspires more confidence in bankers for a borrower wishing to secure the valuable services of note brokers to do so with the knowledge and acquiescence of his banks.

In the statement of the threshing machine company (page 425), it will be noted that among the liabilities on the statement shown there appears at the bottom "Reserve for Dividends and Notes." This company has set up a reserve to take care of their notes when they fall due, which is an indication of a foresighted management.

Occasionally a banker in examining a statement will find the amount of notes representing commercial paper far in excess of bank lines. This indicates an unhealthy condition, and the borrower to enjoy the confidence of his bankers must make an effort to keep his program balanced. Direct bank loans and commercial paper loans should be in such a relationship that the concern can count on one to liquidate the other. To do this either the one or the other should be kept open, if possible, to take care of any emergency which might make it

necessary for a company to liquidate its outstanding obligations.

Notes Payable to Banks, Unsecured.—In order to reassure the bank credit man as to just how the company stands from a loaning standpoint, the commercial borrower should inform him of the maximum amount owed on notes to all sources during the past year, and then the amount of the bank lines enjoyed. This enables the credit man to see what the percentage of borrowing has been to the total amount of bank lines passed, how far the concern is using its lines and what the margin of safety is.

Following are a few precautions the depositor should take in safeguarding his banking relationship.

1. Evidence should be forthcoming that notes will be met promptly.
2. All arrangements made for renewal of notes should be made prior to maturity, so that in case the banker does not wish to renew, it is possible to make plans to pay up. It is often impossible to raise funds to meet bank loans on the day of maturity, and many concerns have been embarrassed when the banker refused to renew their obligations.
3. Steps should be taken to see that all the responsible parties are signed on the notes.
4. The borrower should see that all persons signing on the notes have been authorized to sign by the concern's board of directors as entered in the minute book of the corporation, if it is a corporation.
5. The borrower should be sure that all previous notes paid have been properly discharged, and canceled notes should be produced if the occasion warrants it.

Sometimes a company will have loans payable to bankers and others in the form of notes and will simply list them on the balance sheet as "loans payable." In the statement of a

jewelry company on page 471, an item of $29,648 is listed as "loans payable." The banker finding such a listing separate will want to know what the amount purports to be, whether the loan represents amounts due in notes for paper sold to note brokers, or loans from the bank direct, and will not pass on the credit before he determines to his satisfaction just what the item comprises.

It is for this reason that the borrower should take care to explain to his banker the different forms his obligations take, so that he may understand clearly just how the merchant-manufacturer operates. Moreover, when an item on a condensed statement appears, as in this case, for the first time on the statement, the reason for this initial appearance is also important and needs explanation on the part of the borrower.

Purchase Money Notes.—Occasionally one finds notes, payable monthly, annually or semi-annually which represent purchase money notes. A company will buy some property for a plant site or for investment purposes for future expansion, and will pay part cash and give notes for the remainder of the purchase price. These promissory notes when falling due currently are a current liability and, for that reason, are here considered. The banker scrutinizes the amount, etc., and other factors bearing on this item, and analyzes the statement to see what there is in the way of current assets from other income to offset the item. If current liabilities represented by purchase money notes are out of proportion to the earnings, the financial position of the concern will be unfavorably influenced. The ratio of current assets to current liabilities will become less satisfactory and ultimate financial embarrassment may possibly result in injuring the concern's credit standing.

Notes Due Officers and Employes.—When this item is found in any large amount, it is an indication of weak financial condition, and when examined by the credit man and accountant gives rise among others to the following questions:

1. Are the notes demand notes, and can the money they represent be withdrawn from the business at any time, or are they for long periods?
2. Is it possible that the management holding such notes, by reason of their close connection with the enterprise, might take advantage of the banks holding other notes, in the event of financial difficulty?
3. Is the interest charge on the notes reasonable or exorbitant?
4. If the maturity of the notes is in the near future, will they fall due at such a time as to prove embarrassing?

These and many more questions enter the loaning official's mind when scrutinizing such notes, and the borrower will be looked to for a satisfactory explanation before the credit desired is extended.

Advances by Customers on Purchases.—Glancing down the liability side of the balance sheet form in Figure 14 (page 191) there is shown the heading "Advances by Customers on Purchases." It represents all sums paid by customers on account of merchandise purchased, and is listed separately as a current liability instead of an asset, because the company is contingently liable for the amount in case of failure to complete the transaction. In large corporations this item sometimes is shown in substantial proportions and is carefully studied by the banker. In the statement of a general merchandising business shown on page 437, it will be noted that there is an item of $14,520 set up as "Customers' Credit Balances," meaning the amount the company is holding for their customers pending the completion of the transaction. This amount should always be set forth on the liability side until the amount represented can be truly transferred into the accounts receivable when the company has performed its side of the agreement with its customer.

Trade or Bank Acceptances.—A trade acceptance is a form of time draft drawn by the seller of merchandise on a buyer for the purchase price of the goods or commodities and accepted by the buyer and, like a promissory note, is payable on a certain date and at a certain place designated on its face. Wilber A. Owen, in his "Law Quizzer," says of the effect of acceptance:

"An acceptance is an undertaking on the part of the drawee to pay the bill in money when due. Its effect is to make the acceptor the principal debtor, and to change the liability of the drawer from that of principal debtor to that of first indorser."

The acceptance agreement is written across the front of the paper. Because of its character, the trade acceptance has certain advantages some of which are herewith listed:

1. It differs from an open account in that it is a negotiable instrument.
2. It is an individual acknowledgment of a specified debt, instead of a merely restricted negotiability as in the case of the book account.
3. It is easier for the owner to re-discount with a commercial bank than notes receivable, thereby making it possible to get the money before the maturity of the payment for the goods.
4. It enables the creditor to arrange the definite date of payment with the debtor, which in some instances is of great advantage. It has been the experience of some bankers, accountants, and borrowers, however, that by reason of its liquidity, it, in some instances, tends to stimulate credit inflation.

Looking at it from the banking angle, the borrower is justified in placing the trade acceptance with his banker for discount when entitled to on his statement. With the funds he receives, he is able to liquidate, in turn, his other obligations for merchandise and possibly in some instances, he is able

to take advantage of favorable discounts for merchandise purchased and thereby realize a considerable saving. Again, the discounting of trade acceptances has a distinct advantage in that it relieves the borrower from performing a banking function in the carrying of his accounts and places the operation on a business-like and sound financial basis, which tends to quicken trade, and in one sense makes for increased turnover of capital. The fact that bankers do not generally discount acceptances at any more modest rate of interest than is the case with drafts, has convinced the borrower that he might as well use the simple promissory note with his own endorsement on the back, in many cases, inasmuch as the loaning banker looks almost wholly on the strength of the endorsement for security when extending credit by discounting an acceptance.

Bank Acceptances.—In this case the customer of a bank draws on his banker for a specified amount for 30, 60, or 90 days' maturity and the banker accepts the draft, thereby creating a banker's acceptance. From the borrower's viewpoint the banker's acceptance has the following advantages:

1. It is an instrument for which there is a very broad market, making it liquid paper, readily convertible into cash.
2. The instrument, due to the standing of the bank, and to the fact that its condition is a matter of official inspection and public record, becomes a prime piece of paper, for which there is a big demand, in some cases national and international.
3. The borrower does not get the money from his banker. Thus it would not limit his line of credit to the same extent as it would if he were borrowing direct, in times of stringent money when the bank is hard pressed for funds to loan out.
4. The acceptance of a customer's paper upon the part of an accredited bank makes it possible to obtain funds at a more favorable rate of interest.

Treating Banks Impartially.—In this discussion of notes it is proper to add in conclusion that the borrower should exercise great care to see that every bank from which favors are asked gets the same treatment. Bankers soon lose confidence in a customer who favors now one bank and now another by giving them preferential paper, double-name paper, while it gives others less security as represented by the type of paper.

Thus a bank, when examining a statement, inquires into the trade or bank acceptances item and determines just what the liability is, the specific nature of the transactions and countries involved, the extent of the liability, and the responsibility of those on the paper.[2] A borrower should not have too much tied up in either trade acceptances or bank acceptances, and the same comments made in connection with notes are equally true here, for, after all, 2% 10 days, 30 days net, is most satisfactory for the borrower who is ambitious for a quick turnover of his capital, and who wishes to avail himself of substantial discounts.

Open Accounts Not Due.—It will be observed by referring back to the specimen balance sheet in Figure 13 that there are two items, among others, which might be classified under accounts payable: (1) Open accounts not due, and (2) open accounts past due.

Because the term "accounts payable" is a broad one, the practice of one bank is to divide up its current liabilities representing accounts for merchandise so that they may be more readily analyzed. Open accounts not due are generally thought of as representing all unsettled bills payable for merchandise, materials and supplies, and for other articles purchased for sale, either in its present form or to be manufactured, or for use in the business. Purchase ledger accounts, unpaid

[2] Alexander Wall, Analytical Credits, pp. 67-73.

vouchers, unpaid purchases, and like terms all mean the same thing, and should be listed under the proper heading of "open accounts not due."

Open accounts not due have been further classified, to make clear a borrower's statement, as follows: (1) Those open accounts which have been duly recorded on the books of the company, and (2) those open accounts created not due for which as yet no bills have been received by the company.

With this classification before the reader, some of the more important questions, bearing directly on the condition of the liabilities in the balance sheet, will now be discussed.

1. Are the open accounts payable not due entered by the borrower at face value as the basis of credit from the customer, showing the amount due on account of the purchase of merchandise, and so on?

2. Are all items entered on the books in an account with a creditor, regardless of date of payment called for in terms of purchase, or have some of them been omitted?

3. Bankers and accountants frequently find that business concerns will, when tendering their statement, show the current liabilities ending for the month of December, ignoring December accounts payable which happen to be late. Such items may be stretched out for several months and cripple the company. This is important in some cases, and is given serious consideration by the banker. The borrower gets around this difficulty by having a certified public accountant estimate, or endeavour to determine, when possible, what the amount of the bills will be, and enter the amount in the balance sheet under open accounts not due.

4. The banker will want to know what part of the receivables will come in to assist in liquidating the open accounts payable when they fall due. Also, what amounts fall due next week, next month, etc.

5. Are all bills such as cartage, office supplies, freight, etc., included in the tabulation of the accounts payable? They should be.

6. Sending to creditors and asking them to list amounts owing is done only in desperate cases where a bank is trying to liquidate a dead loan, and where a search is being made to verify balances due, check bills which may not have been entered on the statement; and to dig up any unadjusted items which may be outstanding, but which must be cleaned up before a settlement of the firm's liabilities can be consummated. Thus the question is asked: Are there any items hidden, covered up, lost sight of? If there are, the banker wants to know before he makes a loan, and not after.

After this brief survey of accounts payable it may be well to suggest how the borrower who is slow pay injures his credit with his bank, and to extend a word of caution relative to the proper handling of liability accounts.

1. It is absolutely essential that the open accounts payable be paid monthly, if the usual discount is to be taken advantage of, and it is considered good business to borrow from the bank to do so.

2. Moreover, if any accounts are past due, or if discounts for cash or an early payment have been neglected (not being regularly taken), it seems logical to assume that the concern's financial policy is at fault. In some cases bankers find upon investigation that the reason why discounts are not taken is because the concern is on the verge of insolvency.

3. A banker gets an accurate check on the promptness with which a company pays its bills by comparing the ratio of cost of sales to the notes and accounts payable. When, for example, it is known that a company's terms of purchase are short and it is found it owes for several months' supplies, a danger signal is immediately suggested. To reiterate, a "slow paying business" seriously injures its credit standing.

Changing Payment Policy.—A word of caution here will be timely to warn the borrower against the danger of changing from a policy of payment by notes to payment on open account. If the reader will refer back to the statement of the general merchandising business (page 437) he will note that there is no item of notes payable on the comparative statement for the year 1926, yet during the two years preceding substantial amounts were shown. Why was this? Did the absence of notes payable indicate a change in payment policies? The banker wants to know this. It will be observed also that the accounts payable increased from around $14,000 in 1924 to over $41,000 in 1926. Does this also indicate a change in policy and that the company was now intending to pay its bills on open account instead of by notes? A sudden change might lead to financial difficulty through an increase in accounts payable, which might be inconvenient to liquidate promptly. Hence the necessity of planning carefully ahead when such changes in policy are contemplated in order that no ill effects may result.

When the Borrower Errs in Capitalizing Expense.—Occasionally a banker is approached for a loan when a concern is running behind. Possibly the profits of the company are not as large as they should be, and there is an operating agreement, with the principles depending for continuity upon the profits realized by the management. Consequently, there is often a struggle in such cases between the administration and the management. There is a tendency for the management to attempt to capitalize everything possible in order to keep down expense and increase profits. The banker and the administration, on the other hand, exercise constant vigilance in order to prevent the capitalization of expense. Naturally, in such a situation, the banker feels his way cautiously and is on the alert to prevent the borrower from charging expense liabilities to asset accounts, thereby throwing the balance sheet out of line

and endangering the banker's confidence. In such situations, the commercial borrower should use the utmost care to see that no current liabilities are charged to the wrong account through error, or through the mistake or ignorance of a bookkeeper, who by one mechanical error or oversight may damage his employer's credit with his banker, whose distrust and suspicions may be aroused by only a slight mistake in the direction of capitalizing expense.

Bank Overdrafts.—When a firm or corporation makes an overdraft it should be entered in the column marked for it on the balance sheet. Obviously, a concern seeking credit does not create a favorable impression when an overdraft appears on the statement. A case is cited of a comparison of statements presented of a wholesale hardware company which showed an overdraft entered on the statement for $7,468, while the cash in bank was entered at $7,741. When the banker and accountant stopped to consider that an overdraft was shown and that at the same time notes payable were listed at $207,730, it indicated that the management were not properly budgeting their financial requirements to meet their payroll or were in a position to pay off their accounts payable. No banker likes to do business with a company which overdraws its account, and to present a statement asking for accommodations and showing an overdraft without explanation is a most serious error.

Accrued Property Taxes and Interest.—On the statement of every company there usually appear items of various size which are made up of accrued property taxes due the government and the state. For this provision is made by setting up a certain estimated percentage sufficient to take care of the amount in the statement with a view to ultimate payment upon maturity. Then, too, there are accrued interest charges on current obligations. A separate space is allotted for setting these items up on the balance sheet at their face amount.

As an illustration of how important these items are the statement of a lumber and kraft paper manufacturing company is shown on page 445. It is observed that the amount varied over a period of 5 years from over $1,000,000 in 1922 to $183,495 in 1926. The banker asks for a reasonable explanation of such changes, and has respect for the borrowing management which sets up proper amounts to cover such contingencies as the above with a view to eliminating any difficulty in payment when they fall due.

Accounts Payable to Partners and Officers.—This item covers unpaid salaries or bonuses to officers and employes, and when appearing in good-sized amounts suggests to the banker a shortage of working capital and over-expansion. The reason for this is that ordinarily a firm or corporation pays its employes and officers cash and failure to do so is not a healthful sign. It is sometimes also an indication of poor management, inasmuch as large sums payable to those interested in the business might lead not only to financial difficulty but to disorganization as well. The borrower might do well to keep this item as small as possible. The statement of a lumber, kraft paper, etc., manufacturing company, on page 445 reveals over $18,877 due the officers of the company. The question might arise: If a sudden crisis occurred, would these officers, by reason of their confidential relationship with the company, take advantage of the bankers and other creditors of the company and withdraw their funds, thereby jeopardizing the solvency of the enterprise? The larger this amount due the officers or principals, the more reason has the banker to fear this possibility. Consequently, it is conservative for the management to keep this item as low as possible; and in normal operating conditions it should not be large enough to occasion worry on the part of the banker and his clients.

Deposits.—Among other current liabilities there are what are known as deposits, covering a wide range of items and

comprising several classes. For the sake of clearness it may be wise to list a few of the more common types of deposit accounts appearing on the balance sheets of corporations:

1. It represents funds in trust or for safekeeping for special purposes.

2. These funds may be deposits of relatives or employes, as beneficial or savings funds, which are in the nature of demand loans, subject to withdrawal at any time.

3. Then there are the deposits of customers, as in the case of brokerage firms especially, which have substantial sums held to take care of future transactions.

4. Sometimes salaries are allowed to stay in the firm, and these amounts are erroneously included in deposits, as all such items should be listed separately so as not to be confused.

5. Cash deposits on account of accounts receivable may be made. This means funds set up as a liability, because it represents amounts which a corporation sets aside on contracts not yet completed for such merchandise as it may be found necessary to return. In other words, the purchaser has paid in funds on commodities bought which may not have been delivered, and which it may be necessary for the company to take back, and consequently the funds deposited may have to be returned.

Mortgages or Liens on Real Estate Due During the Fiscal Year.—Under the heading of purchase price notes were mentioned certain amounts of a current nature which a company had to meet currently as the balance payments on the purchase of real estate or plant or similar fixed assets purchased. There may also be notes or payments in other forms falling due semi-annually or monthly for mortgages of long standing, which it is necessary to prepare for by entering the amount for liquidation purposes in the statement under current liabilities. In some instances this item becomes so large as to be out of proportion to the current assets, and causes serious financial

difficulty. In extreme cases the equities are liquidated, the slate cleaned of such obligations, and the company squared away with a stronger balance sheet as a result of closing up such payments through the sale of properties, applying the sums realized to the liquidation of such current liabilities as it is then deemed advisable to pay up.

Other Current Liabilities.—All the current liabilities not already covered may be entered under this heading. In some cases it includes legal expenses currently falling due, franchise expenses, reserves for dividends declared and payable, deferred credits to operation, commission certificates, and such other miscellaneous items.

Window-Dressing the Current Liabilities.—Not infrequently a merchant or manufacturer will become accustomed to "window-dressing" his current liabilities appearing on the balance sheet. That is, the banker will find the accounts payable small on the statement, but upon further investigation he learns that to bring this about the borrower has had to force income payments, has had to curtail his operations temporarily, and has severely hampered the progress of the company through failure to buy needed materials to carry out production schedules, and has done so simply to make a good showing in the statement he presents to the banker.

Obviously, bankers are loath to make advances of funds under circumstances of this kind, when it is difficult to get a true picture of the risk by reason of this distortion, merely to be able to show the banker a strong ratio of current assets to current liabilities.

A comparative analysis of statements from year to year will reveal to the borrower the periods at which his current liabilities will be at their peak. In this relation, statement dates are important. Some concerns, by the very nature of the business, will have an excellent statement with practically no liabilities at

one season of the year, and at another may show a much less favorable statement with large liabilities. Thus it is important in such cases to give the bank a statement, one at the low point, and one at the high point of activity, when liabilities are greatest. By estimating his probable requirements in advance the borrower can make a reasonable request for a loan from his banker to tide him over this period, and by so doing preserve a well-balanced financial program.

CHAPTER XI

LONG-TERM LIABILITIES AND CAPITAL

Long-term liabilities, or "fixed" liabilities, are so called because they are not currently due. Obligations of this character, because they represent large sums of fixed capital invested in a business, are of great importance to the banker making unsecured loans. As companies grow, the need for new permanent capital makes necessary the issue of bonds, mortgages, and other funded obligations. The complex structure of the big consolidations, which each day become more numerous, increase the complexity of banking credit, and put a heavier responsibility upon the banker, who to cope with it, makes a more scientific analysis of his credit problems and employs a staff of expert economists and trained credit men to help him decide upon the merits of the offerings for both secured and unsecured credit accommodations.

Banker's Viewpoint on Large Capital Liabilities.—In this era of growing business consolidations, with their long-term credits, it is well to know the banker's attitude toward the extension of credit as expressed by those eminent in the profession. The safety of the credit risk as affected by the magnitude of the consolidation creates a special problem. To throw some light upon the question there will be given briefly the banker's reaction as expressed in a round-table opinion of financial authorities toward railroad, power, food and other consolidations, and the liabilities created by them. These expressions of opinion are significant, coming as they do from institutions which are responsible for a big share of world-financing, for the extension of funded credits in the form of

bonded indebtedness, and for increased capitalizations. They reflect the attitude of bankers from the credit standpoint, toward large-scale enterprise.

George E. Roberts, vice-president of the National City Bank of New York, says: "We have clung too long to the economic absurdity that large-scale corporations are bad for the community just because they are large. If a great business genius, through operation on a big scale, is able to accumulate millions, what of it, if he has contributed toward the betterment of his community?"

The student of finance may infer from this remark that as long as large-scale enterprise is not harmful and has the confidence of the public, it is sound, and warrants the extension of banking credit to foster it.

Francis H. Sisson, vice-president of the Guaranty Trust Company of New York, says of the ethics of consolidation: "Economy in production, small margins of profit, quick turnover of capital and, hence, lower cost to the consumer, are becoming more and more the watch-words of business men, and it is perfectly obvious to men of natural intelligence that these ends can better be attained through efficient operation on a big scale. The American people are gradually being convinced that, so far as harmful practices are concerned, the size of a concern bears no relation to its business ethics. If there is to be governmental oversight over the conduct of business, it would be much easier to watch a few big business men than thousands of small dealers."

From the foregoing the borrower may conclude that as far as the moral risk is concerned, bankers are not inclined to limit the amount of their accommodations because of the magnitude of an enterprise.

John C. Cowdin, a member of the firm of Blair & Company of New York, says: "Whatever America has gained in her standing as the home of men of business acumen has been gained through the operation of big business. I see absolutely

no limit to which it can be carried, with profit to the country as an economic factor in world trade, so long as these corporations are run on sound economic principles." [1]

From this the borrower might conclude that big business, with the creation of a gigantic funded indebtedness, will enjoy the confidence of the banks so long as the management functions efficiently, and the credit risk warrants the public trust.

The question might well be asked. How does the banker feel about extending credit to the small borrower who is burdened by funded indebtedness? It may safely be said that no banker cares to grant unsecured credit to a small concern which is topheavy with funded debt; but the same criteria which will be outlined in the consideration of funded indebtedness in the discussion to follow applies as well to the small company as to the large, for the principles in both cases are fundamentally the same.

The Viewpoint on Small Capital.—In almost every line of business, there are concerns which have bonded debts or mortgages payable. Not infrequently the banker finds a small concern doing a manufacturing business in an old structure, or warehouse on which they may hold the fee, but in order to raise more working capital, they may have mortgaged their property for one-half to two-thirds of its value. When set up in a financial statement it is thus so heavily incumbered as to show but little asset value.

Occasionally the banker is approached by a depositor operating a small business who is short of working capital. The depositor may want to borrow, say, $25,000 on his plant, real estate equipment, and other fixed assets. Now the banker finds it difficult to sell so large a mortgage, and consequently is not anxious to make a first mortgage. But what about a bond issue? The answer is that it is expensive to make a bond issue of only $25,000, owing to the commission the banker must

[1] *The Chicago Banker*, February 13, 1926, p. 15.

charge to float the bonds. Even a small banking institution is not much interested in a bond issue under $50,000, as it is otherwise too expensive and troublesome to handle. It is for this reason that small funded obligations are not popular with bankers, who, while not adverse to making suitable mortgages, do not care to handle costly small bond issues.

It is for this reason that borrowers showing small amounts of $25,000 to $50,000 in funded debt on their statements are encouraged to sell stock, and by so doing to be in a position to take up outstanding obligations and increase their working capital. This eliminates the difficulty and expense of financing and refinancing small funded obligations, which are too large to finance as mortgages and too small for profitable bond issues.

The foregoing considerations are of much importance when looked at from the viewpoint of unsecured banking credit. This is because the extension of this credit to industry depends upon a close interrelation between funded debt on the one hand, and current debt on the other. Upset the financial structure upon which banking credit is based, and the whole organization comes down with a crash. Inability to meet the funded debt payments when they fall due means inability also to meet the current liabilities and consequent failure. The reverse also is true. Inability to meet current liabilities carries with it the penalty of not being able to meet the funded indebtedness. Thus inseparably linked together, long and short-term liabilities receive the close scrutiny of the loaning banker in their relation to each other. By analyzing one in relation to the other the banker decides whether he is warranted in extending unsecured credit.

Moreover, it is apparent that only adequate earnings will protect a banker making funded loans secured, or unsecured; and, as Charles E. Mitchell, president of the National City Bank, of New York believes, the old yardstick measure of security values, as represented by fixed assets, is about to be

supplanted by earning power which, he says, "If we can be sure of it, is a better method of measuring values." [2]

By correlating all his deductions from the analysis of the current items on the balance sheet with those obtained from studying the structure of the funded liabilities, the banker gets a constructive picture of the credit risk, and can decide whether the financial program outlined by the management will work out so that current and fixed liabilities will be liquidated without difficulty in due course of operation.

It is the purpose of this chapter to discuss funded indebtedness and capital structure as appearing in the statement, and not to go into too detailed a discussion of those elements which, while vitally connected with the subject of unsecured credit, are still of interest, in the present instance, only as to how they affect the banker's decision in making unsecured accommodations.

For purposes of discussion the fixed liabilities will be divided into the following classes:

1. Bonded debt, amount due after fiscal year
2. Mortgages or liens on real estate, due after the fiscal year
3. Chattel mortgage notes
4. Other liabilities

Bonded Debt, Amount Due After Fiscal Year.—On the statements of many large companies bonds and mortgages payable are often found to represent a large share of the fixed liabilities. The borrower who desires unsecured credit must put himself in the position of the loaning banker. The banker when making an unsecured commercial loan, is not buying an interest in the business, nor is it his intention to loan out his funds indefinitely. Consequently he looks at the bonded debt primarily to determine whether the company will be able to carry the interest charges, and will be able to meet the portions of principal as they fall due from time to time. He is

[2] Charles E. Mitchell, "Earning Power Basis for Credit," *The Chicago Banker*, February 6, 1926.

also vitally interested in determining whether the bonds are amply secured by mortgages. Otherwise they constitute a lien upon the general assets of the concern, and in the event of liquidation the unsecured residue would share equally with the claims of other creditors. This, of course, might work out to the banker's detriment in securing payment of his notes.

For the borrower and the banker there are many confusing angles which arise in determining just what is the equity back of the bonds, and only a searching investigation will indicate the extent of the security. There are many different types of bonds, secured and unsecured, and it will be only necessary here to comment briefly on the differentiation of the several classes and to illustrate how the banker classifies them.

There are many kinds of secured bonds. Some of these are first mortgage, first and refunding mortgage, consolidated mortgage, and general mortgage. A banker may find upon analyzing an issue of bonds entered on the statement as a first and refunding mortgage that they are in reality first mortgages on only a small fraction of the total property. Indeed, on the greater part it may be only a second, third, or fourth lien. Under such circumstances the titles of first and refunding mortgages are not justified, and are plainly misleading to the banker and the investing public, being attached to the bond for the sole purpose of increasing its salability. When the loaning banker finds conditions which justify him in his belief that a company's bonded indebtedness is not all that it purports to be, he may drop the company altogether so far as immediate credit is concerned. If, however, the management is honest, and is simply misguided in their bonded structure, the conservative and constructive banker may help out in a reorganization, and place new liens on the company's property, taking up the old and thereby placing the concern in a stronger financial position.

Secured Obligations.—Collateral trust bonds, and "secured" bonds are promises to pay secured by a pledge of cer-

tain collateral, the bonds being not only backed by the direct promise of the company to pay, like the unsecured obligations, but having the additional value of the pledged collateral. When the banker goes into the consideration of these types of bonds,

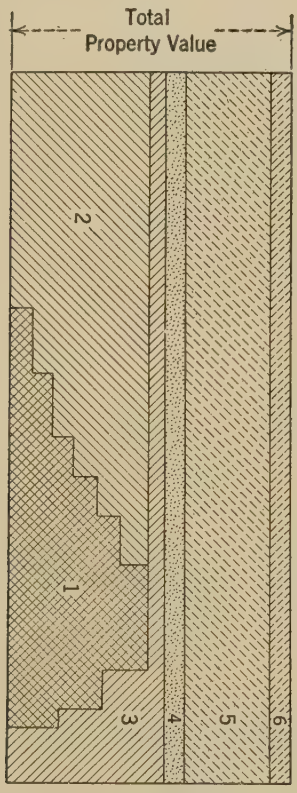

Figure 15. Diagram Illustrating Financial Structure of the Chicago & North Western Railroad

he asks the nature of the securities pledged, sees whether the minutes of the board authorize the issue, and looks into other matters relating to them if there is any question as to the correctness of the debt.

Upon investigation the banker finds a corporation's finan-

cial bonded structure can be readily analyzed from the investment standpoint as well as from the point of view of current indebtedness. It is now proposed to take up here the order of precedence in the different obligations.

First in point of lien and security come the first mortgage bonds, and next the bonds secured by junior mortgage. Following the mortgage obligations comes the unsecured debt, such as debentures, then the first preferred stock, the second preferred stock, etc., and finally, the common stock. Many corporations have a much simpler financial structure than here outlined. But whether simple or complex, the proper perspective can always be obtained by visualizing the various securities with respect to the order of their claim upon assets and earnings, those with prior claims being naturally the strongest.

By way of illustrating the foregoing the diagram in Figure 15 shows the approximate financial structure of the Chicago & North Western Railroad. The differently shaded sections represent various security issues, as follows:

1. Underlying divisional bonds secured by liens upon certain portions of the property.
2. General mortgage bonds, secured by first lien upon a substantial part of the property (in this case a main line mileage) but subject to No. 1 on certain of the mileage covered.
3. First and refunding mortgage bonds and bonds secured by pledge thereof. A first lien on certain limited mileage but subject to No. 1 and No. 2 on the remainder.
4. Preferred stock. (The stocks represent the equity or value of the property over and above all debt.)
5. Common Stock.
6. Property value in excess of the total capitalization.

For the sake of discussion, suppose that at the present time the Chicago & North Western, in addition to interest on its bonds, is paying 7% and 4% respectively on its preferred and

common stock. It is conceivable that adverse conditions might compel suspension of dividends on one or both classes of stock, but it can readily be seen that the bonds, particularly Nos. 1 and 2, are well secured and in a strong position.

Mortgages or Liens on Real Estate.—In a previous paragraph in this chapter reference was made to the part played by earnings in the financial strength of a company. It is true that the value of a heavy investment in fixed assets on the part of a borrowing company is often much dependent upon the continued operation of the concern, and that when earnings cease and liquidation results, the fixed assets greatly shrink in value, often proving insufficient when sold to pay off the bonds they are presumed to secure. Yet, while earnings may be a convenient yardstick for measuring security values, bankers still look for the security for all mortgage bonds, and particularly first mortgage bonds, largely to the value of the fixed property made up of the land, buildings, equipment and the like upon which the mortgage is a lien. A corporation may have large assets in the form of inventories, accounts receivable, securities owned, etc., all of which taken together are known as current assets, but the mortgage bonds having a prior lien upon the fixed property are more closely concerned with the value of plant and equipment than with the value of current assets.

When a bank is considering the loan of funds to a corporation which has heavy mortgages on its fixed assets, it requests certified appraised valuations by unbiased appraisal companies. If it is believed that the fixed assets are too heavily burdened with mortgage debt, the bank may refuse to extend short-time credit, fearing that in the event of financial difficulty there would be little left for the satisfaction of bank loans after the heavy mortgages were paid off, providing the current assets were not sufficient to pay off the current indebtedness. Thus it is that when the banker is examining the mortgages

appearing on the statement, he looks to see if there is a high percentage of fixed assets as compared to the total assets, and an ample margin of equity to secure the obligations.

When adjudging the strength of the mortgage bonds, the banker also takes into consideration whether or not the plant and equipment securing them are indispensable to the operation of the company. In the case of railroads, public utilities, steel companies and other industries of a similar type, the equipment is necessary to existence, and mortgages placed on such properties are in consequence in a strategic position. On the other hand, bankers find that the mortgage bonds of companies whose assets are largely current, and whose plant merely serves to house the business, are not in the same fundamentally strong position. In the former case the mortgage bondholder has a lien upon the bulk of the assets and the source of the earning power, while in the latter case his position is weakened by the fact that his security is not vital to the business.

Relation of Total Assets to Total Debt.—While the banker loaning on the unsecured basis, or as a bondholder, is primarily concerned with the current position of the company, and with the proportion of mortgage debt to the fixed assets, still it is essential also to consider the relation between the total assets and the total debt. A corporation can meet with adversity from an excessive debt, but, on the other hand, it may be strong enough to go through a reorganization without a loss to the bondholders. But there is obviously no object in extending credit to a company with property loaded down with an excess of junior indebtedness. From the standpoint of commercial loans and from an investment banking angle, debt is debt, whether secured or unsecured, and ability to carry the total burden is consequently of importance to the lending banker.

Unsecured Obligations.—So far the discussion has had mainly to do with secured obligations. Unsecured obligations

will now be considered. Notes, debentures and other unsecured long-term obligations, which in the main are industrial issues, are judged by the banker from a somewhat different viewpoint from that applied to mortgage bonds. Having no specific lien on any part of the property, unsecured bonds are strongest when current assets predominate. When the analytical banker investigates unsecured obligations outstanding, he consequently weighs not only their amount in relation to the current assets, but studies carefully the character of the quick assets. In the previous discussion it was pointed out that quick assets were so called because they can nearly always be liquidated or sold within a short time. It has also been indicated that real estate and plants, on the contrary, are often difficult to dispose of promptly at a satisfactory price. It is for this reason that bankers asked to extend accommodations, and holders of unsecured obligations, are deeply interested in current assets which can easily be converted and applied against the debt.

In the preceding chapter reference was made to the significance of the ratio of current assets to current liabilities. The subject of current assets as related to unsecured long-term indebtedness brings up also that of current liabilities. It will be well to note that in our previous analyses all unsecured current obligations, such as loans from banks, trade accounts payable, taxes, interest accrued, etc., were deducted in order to arrive at the net current value of the quick assets. In determining the strength of a statement in which there appear unsecured long-term obligations, the banker takes into consideration the excess of current assets over the current liabilities which gives the net current assets applicable to the funded or bonded debt. If it is found that the net current assets ratio is not high, and it is likely that there might be some difficulty in meeting interest payments on the funded indebtedness, the banker does not care to extend credit and may recommend,

where the current assets seem to be much too small, that additional working capital be sought, either by selling more stock or by taking up the old obligations and replacing them by new ones which will provide sufficient new funds.

An industrial corporation is generally in a weak position unless, as we have said, current assets are at least twice the current liabilities and the remaining current assets are substantially in excess of the unsecured funded debt. Preferably the current assets should be equal to twice all current liabilities and unsecured funded debt combined, but as already indicated, there are many influential factors to be taken into consideration tending to change the relation between the items appearing on the statement. Only a well rounded analysis, taking into consideration all the circumstances of the case, will enable one to weigh accurately the values set forth.

Regarding the matter of prior liens, it is obvious that notes and debentures are weakened if preceded by any substantial amount of mortgage bonds and are fundamentally soundest when the corporation has no mortgage debt and covenants to create none. Occasionally the unsecured obligations are protected in much the same way by an agreement to include them under the security of any mortgage subsequently created.

Earning Power in Relation to Funded Debt.—In some banking quarters there has been a tendency to judge the ability of a corporation to pay off its funded indebtedness, and the safety of the bonds themselves, upon the basis of the earnings of the corporation. Experience indicates that up to a certain point there is considerable justification in this attitude. A company which is a good earner can easily carry a heavy debt. But earning power above the average is sometimes less dependable than it at first appears. It may have resulted from a combination of circumstances whose effect is shortlived, as in the period following the war; and any one of a great number of conditions, such as the following, may reverse matters:

1. Earnings may be temporarily lost, or seriously curtailed by a business depression.
2. New inventions may antiquate the process or business procedure of some phase of the business.
3. Excessive competition may curtail profits.

Under such circumstances the credit of the corporation and its ability to continue operations depends upon the extent of its assets in comparison with its liabilities. Moreover, if the property has been heavily bonded during a preceding period of prosperity, it may find further borrowing impossible, once conditions take a turn for the worse, and be forced into insolvency through lack of sufficient working capital. It is for this reason that the banker, in committing himself for accommodations, or in buying bonds, feels that the ideal situation is a combination of good earnings and ample assets, for a really strong company is generally found to be amply protected in both respects.

This question of earning power in relation to funded debt, or more particularly in relation to interest charges on the debt, is an exhaustive study in itself. Suffice it to say here that for the banker or investor whose judgment must be based upon past results, the most important consideration is stability of earning power. A corporation which has shown earnings equal to twice bond interest requirements over a period of ten years is a far better risk than one whose earnings fluctuate widely from year to year. Theoretically, the banker is interested only in knowing that earning power is sufficient to cover interest payments, but as a practical matter there must be some margin of safety over and above requirements to provide for unforeseen contingencies.

Consequently, if earning power is unusually stable, as in the case of public utilities, a record of earnings equal to twice interest requirements is ample. With industrial companies a much higher ratio is necessarily required because they are much

more sensitive to business conditions and their earnings tend to fall off sharply during periods of depression. Railroads, from the standpoint of earnings, are judged upon much the same basis as utilities, with the exception that at present allowance must be made for the effects of government operation, and of post-war economic conditions which have borne heavily upon certain of the railroads. From some angles it is believed that railroads are favored by the statutory provision that rates must be high enough to produce an average return of 5¾% upon the capital invested. This provision does not reassure bankers loaning railroads or investors buying securities particularly, as it is the experience of railroad operators that earnings should be in excess of this rate during good years to provide a surplus to care for the deficits of the lean years. Thus this provision, if kept in force, promises nothing to any particular road but a living wage to the average well-located and well-managed property. It is, however, deemed worth taking into consideration in evaluating the bonds of such a road, when the total debt is materially less than the property value.

The Limits of Bonding Power.—What are the various theoretical limits upon the bonding power of various classes of corporations? The answer is that in a general way a railroad or public utility should not be bonded for more than 66 2/3% of the value of fixed property, and an industrial for not more than 50%. Much depends upon earning power in determining whether these ratios are actually high or low. For example, a corporation earning 15% on its invested capital would obviously be more conservatively bonded at 75% of its value than another property earning 5% of its valuation and bonded for 50%. The most reliable figures on the valuation of railroads are those determined by the interstate commerce commission. For example, investigation shows that a public utility's valuation (electric light, power, and gas properties) can be gauged with reasonable accuracy by comparing the capi-

talization with the annual gross earnings. If the total capitalization does not exceed 4½ times the gross earnings, and the debt not more than 2¾ times, it is a fair presumption that both are reasonable. The value of industrial properties is generally based upon independent certified appraisals which more often err on the side of liberality than otherwise. Bankers find that, as there are exceptions to all rules, in many instances the above observations do not hold, but afford merely a guide which a banker or borrower will find convenient in working out a basis for consideration.

The Importance of Diversification to the Banker.—No matter what may be the security, all loans carry some element of risk however careful a selection the banker makes of his borrowers. It is, therefore, the aim of every careful banker to reduce this risk to a minimum, and to this end one of the most effective principles which all worthy bankers observe is that of diversification. Diversification is nothing more than the law of averages; it recognizes the presence of risk and seeks to reduce it by spreading funds over a great many concerns representing industries of various types separated from one another geographically. Anyone can appreciate that a certain set of conditions might arise which would not necessarily harm the steel, or textile, or agricultural implement business. Consequently, the banker whose loans are distributed among all these industries would suffer less than an investor who held nothing but utilities. It is likewise true that a crop failure or other contingency which might retard business in North Dakota would not necessarily affect Ohio or New York industries. Hence, the precaution of diversifying loans should always be taken by the banker, and by the borrower in making investments. No banker fools himself into thinking that diversification will create immunity from loss, and it is in no wise a substitute for proper discrimination on the part of the bank in selecting its borrowers, but it is a sound principle and a valu-

able safeguard, which limits the amount of funds a banker feels can be safely put out in one industry or one locality.

Basic Industries Favored by Bankers.—A further principle for the borrower to observe is that related to the tendency of the banker and seasoned investor to favor the so-called basic industries whose products or services are an everyday necessity. Fuel, food, transportation, power, and light are the chief of these, but the list could be expanded by the addition of innumerable other lines which hold an assured position in our economic life. Bankers find from loaning to businesses of this character that they have a far greater stability and a more certain future than industries which manufacture or deal in luxuries or semi-luxuries.

Tendency to Avoid New Companies.—It goes without saying that a bank will not sidestep loaning funds to a company unsecured, or issuing bonds simply because it is new. Yet new companies launched during periods of prosperity are naturally looked upon as more of a speculation than those more seasoned and financially weathered by experience. The mortality among such undertakings is found to be particularly high, and unless a business has passed through at least one period of depression, bankers are apt to be skeptical of the ability of a company which has not shown sufficient financial fortitude, under adverse business conditions, to pay off its funded indebtedness. The reason for this can readily be seen when it is realized that a business depression overtakes the country about once in 7 years. These periods of adversity always result in keen competition, which serves to eliminate the weak and inexperienced. Bankers find that under such conditions a new business has great difficulty in competing with old established organizations with large resources, high credit, and established trade conditions. On this account great numbers of new undertakings, as Dun's, and Bradstreet's reveal, go under within a few years of their inception.

Purpose of Loans Important.—Sound financial procedure also takes into consideration the purpose of short and long-term borrowing. If temporary funds are needed to assist a company to take its discounts, or if bonds are sold to provide funds for reasonable and needed expansion, the purpose of the loan can be regarded as satisfactory. But if, as is often the case with corporate financing, the funded debt shown on the statement represents nothing more than bonds sold to enable the owners to withdraw all or a good part of their investment, and at the same time to retain control, the situation is different. It has been the experience of most bankers that it is best that the owners have an actual and substantial investment in the property junior to any bonds outstanding, for such an investment is by far the most satisfactory assurance of conservative and efficient management. Under such circumstances a banker has reason to believe that a serious attempt will be made by the owners to liquidate the funded debt, and also to pay off all temporary short-term borrowings to protect their interest in the company.

The commercial banker is not a pessimist in his attitude toward borrowers, but disappointments, and heavy losses have taught conservative bankers that ample security is of prime importance in adversity. It is of no particular value if everything goes well, but is vital if everything goes wrong, and thus the banker fortifies himself against any possible combination of adverse conditions, and thereby safeguards himself from loss.[3]

Things the Borrower Should Watch and the Banker Check.—Before going into more detailed discussion regarding other fixed liabilities it might be worth while to cast up here a few of the more common things the borrower should be cautious about in relation to the presentation of funded indebtedness, and which the banker checks before granting accommodations:

[3] Investor's Section, *The Economist*, July, 1924, p. 32.

1. All bonds and mortgages payable should be shown as a liability, and not a deduction from assets on which they are a lien.
2. The assets on which funded indebtedness is a specific lien should be indicated.
3. The title of all bonds should be given on the balance sheet, such as first mortgage, second mortgage, third mortgage, and the like.
4. The relationship of bonds to the total authorized outstanding obligations should be shown.
5. If there are serial bonds on which current payments must be paid, those falling due should be listed in separate columns, as provision in a specified time must be made.

To illustrate how a concern can show its assets and liabilities to advantage, and bring out the different relations of each over a period of years, the comparative condensed balance sheet of the Goodyear Tire & Rubber Company is shown in Figure 16. It is noted that the different classes of stocks are set forth. Prior to 1921 it will be noted there was no funded debt, but owing to the deflation they had to issue securities to care for their heavy losses in inventory, to pay accumulated current obligations, and to increase working capital. A detailed discussion of the funded indebtedness follows. On the comparative balance sheet the funded debt is lumped, making it more easy to compare with the other items on the statement.[4]

Stipulations Important.—In making bond issues banking institutions set forth certain provisions or stipulations which protect bondholders and the banks, and which must be carefully lived up to by borrowing concerns. From the illustration afforded by the Goodyear Tire & Rubber Company it was stipulated that a banker's committee should be put in control of the company, it being stated that "during the life of these bonds control or management of the company, through the right to elect a majority of the board of directors, will be vested in

[4] Moody's Analysis of Investments for 1924.

COMPARATIVE CONDENSED BALANCE SHEET, AS OF DEC. 31

ASSETS:	1923	1922	1921	Oct. 31, '20	Oct. 31, '19	Oct. 31, '18
Plant and property	$ 49,957,584	$ 51,764,608	$ 53,126,735	$ 55,193,486	$ 35,260,507	$29,785,046
Patents, trade-marks and designs	.....	.....	.....	1	1	1
Advances, etc.	30,795,685	31,888,502	29,690,258	38,924,906	5,577,885	5,590,235
Marketable securities	799,462	11,197,319	9,469,180	.....	6,726,403	5,363,503
Inventory	28,355,175	30,585,737	32,232,777	41,167,758	35,566,779	30,507,967
Accounts and notes receivable	*14,225,503	12,062,903	10,194,500	15,769,625	24,960,095	14,979,635
Cash	13,204,649	10,334,180	14,423,640	1,667,737	10,395,241	6,344,490
Other assets	12,500,000	12,500,000	12,500,000	353,327	182,076	208,324
Deferred charges	4,175,353	6,176,779	6,818,685	.....	1,280,851	690,181
Treasury securities	2,086,000	2,291,978	.....	.....	326,993	149,636
Deficit	.....	.....	.....	15,647,654	.....	.....
Total	$156,099,411	$168,802,006	$168,455,775	$168,724,494	$120,276,831	$93,619,018
LIABILITIES:						
Prior preference stock	$ 15,000,000	$ 29,902,500	$ 29,662,900	†$ 66,133,523	†$ 23,173,900	†$23,783,800
Preferred stock	65,079,600	65,079,600	65,079,600	.....	‡13,497,400	‡15,000,000
Common stock	1,000,000	1,000,000	1,000,000	59,894,727	20,757,600	20,466,800
Management stock	10,000	10,000	10,000	.....	.....	.....
Funded debt	51,250,000	55,250,000	56,750,000	.....	.....	.....
Accounts payable, etc.	7,612,708	5,411,482	6,210,229	40,979,668	21,785,484	8,083,483
Reserves for conting., etc.	4,360,967	4,139,881	6,123,003	1,716,576	7,729,781	5,567,579
Surplus	11,786,136	8,008,543	3,620,043	.....	33,332,666	20,717,356
Total	$156,099,411	$168,802,006	$168,455,775	$168,724,494	$120,276,831	$93,619,018

* Includes $3,000,000 call loans. † First preferred stock. ‡ Second preferred stock

COMPARATIVE STATEMENT OF WORKING CAPITAL, AS OF

	1923	1922	1921	Oct. 31, '20	Oct. 31, '19	Oct. 31, '18
Current assets	$56,584,789	$64,180,139	$66,320,097	$58,605,120	$77,648,518	$57,195,595
Current liabilities	7,612,708	5,411,482	6,210,229	40,979,668	21,785,484	8,083,483
Net current assets	$48,972,081	$58,768,657	$60,109,868	$17,625,452	$55,863,034	$49,112,112
Ratio	**7.43**	**11.86**	**10.68**	**1.43**	**3.56**	**7.08**

Figure 16. Statement of Goodyear Tire & Rubber Company Showing the Set-up of the Different Classes of Stock

Clarence Dillon, of Dillon, Read & Company." This was necessary to insure reorganization policies being carried out, and to protect the bankers and bondholders in their interest in the company under the plan of reorganization. Failure to follow stipulations is often reflected in the balance sheet, and bankers demand that terms of agreement be lived up to before they will extend further credit, whether for temporary or long-term financing.

Some of the more common stipulations which are reflected in the balance sheet, and which frequently play an important rôle in financial set-ups, are as follows:

1. Provision for the control of a company during the life of the financing in case of reorganization by bankers or others.
2. Provision for the annual or semi-annual retiring of a fixed amount of the obligations outstanding.
3. Stipulation that all bonds shall be a first mortgage on all the property of the company now owned or hereafter acquired.
4. Stipulations for pledging with the trustee stocks and other securities of subsidiary corporations.
5. Provision that the company shall maintain a certain ratio of quick assets to the first mortgage debt, as above, and that they shall be at least 125% of the first mortgage bonds outstanding.
6. That net quick assets shall be equal to a certain specified per cent, say 150%, of all indebtedness other than the first mortgage debt.
7. That the issue of securities shall be listed or not listed on the New York Stock Exchange.
8. That a sinking fund shall be created into which a specific amount named shall be deposited for liquidation purposes at certain times of the year.
9. That a certain amount of interest will be guaranteed the holders of specified obligations.

The above merely serves to indicate to the reader the general character of stipulations which may become complex, and at times result in such involvement that it takes a corps of lawyers to straighten affairs in case of financial difficulty.

It is sometimes found in analyzing the funded indebtedness that stipulations may make for financial ruin if their effect is not anticipated. Sometimes the sinking fund provisions are so rigid that a shortage of working capital finds the company paying funds into the sinking fund which are vitally needed to sustain the life of the corporation. Again, there will be guaranties made by a parent or affiliated company to pay a specified interest on outstanding obligations. When financial trouble arises, such guaranties have been known to handicap a company so severely that a reorganization was the only solution. Such was the case of the Interborough Rapid Transit Company of New York which guaranteed the stockholders of the Manhattan Railway a certain rate of interest under a lease agreement. The stipulation under adverse operating conditions became so severe that a reorganization was necessary to adjust the provisions that made continued progress impossible.[5]

Chattel Mortgage Notes.—Sometimes a company will show considerable indebtedness of a fixed character on the balance sheet in the form of chattel mortgage notes, obligations often representing equipment or fixtures purchased. These are promissory notes, and provide that the company furnishing the equipment, fixtures or other chattels, meaning movable goods, may, upon failure of the purchaser to meet the agreement of payments set forth, reclaim possession of the chattels. These notes are usually made out to run over a period of from one year and 6 months to several years, depending upon the terms.

It is essential, in analyzing a statement setting forth such obligations, to know how long they are to run, the rate of interest, and what provision the borrower has made to take care

[5] See reorganization agreement, Moody's Analysis of Investments, 1923 Public Utilities, p. 1630.

of the payments when they fall due. Such items are common on the balance sheets of new hotel corporations, which find it practical to buy their dishes, kitchen utensils, and bedroom furniture and other fixtures on time payments and give chattel mortgage notes in large amounts covering payments over a period of months, or even years. The important consideration is whether the earnings will be sufficient to meet the notes as they fall due, or whether a default will result in foreclosure and the failure of the undertaking? Restaurants and many other types of business give chattel mortgage notes, and in the case of small establishments it is common for large houses to grant them credit on the security of chattel mortgage notes, and to foreclose in case of inability to meet the notes and take out their fixtures and other removables put in, thereby leaving the debtor with a bankrupt establishment both from an operating and a financial standpoint.

Other Liabilities.—The term "other liabilities" is a broad one, and embraces such a wide range of obligations as to make it inadvisable to more than suggest to the borrower a few of the more significant, and to point out some things relative to their treatment which require special attention. Under the heading "other liabilities" may be included the following:

1. Contracts for future delivery
2. Judgments
3. Audit fees
4. Unclaimed dividends
5. Certificates and coupons not redeemed
6. Containers
7. Reserve accounts
8. Contingent liabilities

The fact that "other liabilities" include what is left over—one might say, the odds and ends unsettled for by a company—is all the more reason why the banker scrutinizes them the more keenly. Appearing last on the financial statement does not at

all mean least in importance. In fact, among these items may lie the key to the whole financial situation, determining success or failure to secure the banker's co-operation. Bearing in mind the foregoing let us now take the group of "other liabilities" individually.

Contracts for Future Delivery.—There are many corporations which make contracts for future delivery for a wide range of commodities and for numerous reasons. For a manufacturing concern it is often necessary to arrange long in advance for the receipt of materials needed in their manufacturing process. Again, contracts for future delivery may, in some instances, mean considerable saving. Moreover, the nature of the merchandise sought may make it impossible to obtain it except by contracting for future delivery during certain seasons of the year.

Naturally, when a company contracts for future delivery, there is a financial obligation connected with it, and just how serious this obligation will prove to be depends upon a number of things. But of all these the condition of the market is of primary importance. Following upon the period of inflation when the bottom dropped out of the market, there were tremendous losses sustained by corporations due to the contracts for future delivery which could not be canceled. Leather companies, sugar refineries, packers, and manufacturers of all kinds, found themselves sustaining heavy losses whenever shipments which had been contracted for in advance came in and had to be settled for on a basis far above the prevailing market.

Banks going through liquidation experiences with corporations which had made unwise contracts for future delivery learned a severe lesson, and today they are alert when analyzing a statement showing contracts of this character. They want specific questions answered which bear directly upon the liability of the company, and among the more important interrogations are the following:

1. What is the extent of the company's liability in money involved, and what is the character of merchandise contracted for? Does the contract call for staple commodities or unstaple, perishable or imperishable? These are important considerations in case of fluctuating markets.

2. What is the depositor's known ability to meet payments? Will it be possible for him to take care of the payments on the contracts for future delivery when they fall due, in addition to the other obligations which must be met in the usual course of business?

3. Have the prices of goods ordered for future delivery dropped? Do market conditions point in that direction?

All the above questions and many more like them must be answered by the borrower in presenting contracts for future delivery to the banker, who will not be inclined to give support unless the credit situation warrants his confidence, as borne out by the answers to the questions which are essential to commitment.

Judgments.—A judgment, legally speaking, "is the conclusion of law, upon the facts of a case judicially ascertained, pronounced by a competent tribunal having jurisdiction in the premises, in a matter regularly before it for adjudication."[6] In business parlance it merely means that there is a liability outstanding that the firm, individual or corporation must settle either by payment, by property, or by some other means.

When the banker is contemplating granting unsecured credit, he will look through a special report of some kind for any judgments which might prove a serious liability, and might bear directly upon the goodness of the risk, and ability to pay up. If a large judgment was outstanding, the bank would want to know the why and how of it, and whether the financial condition would make payment difficult. The fact that experience has proved that judgments have put numerous companies out

[6] Owen's Law Quizzer, p. 186.

of business makes the banker cautious when judgments of substantial import appear on the statement.

What gives rise to judgments? Often they are the result of litigation over patent rights, deliveries, contract stipulations, and lastly as a result of quarrels with customers over purchases. Frequent judgments appearing in the record of a company are a bad sign, and are often a reflection on the management, the operation, and the product. Executives who are unable to merchandise products without litigation are usually found to be either lacking in business training or to be foolishly stubborn and over-anxious to do business on their own terms. Again, the operation may be faulty, resulting in an output not up to the quality advertised. Lastly, the product itself may be wrong, and may not perform what it is claimed it will because of some inherent defect. All of these things give bankers some right to assume that if business men in general cannot get along with a concern without litigation, they themselves cannot expect to get along with that concern. Consequently, they are not keen to extend unsecured credit for fear of personal litigation, or for fear that the company might get into some financial difficulty and be unable to pay its loans.

Audit Fees.—It is claimed in some quarters that audit fees, because they are difficult to determine in advance, should not be entered on the statement. Yet, from a banking and accounting angle, if it is customary to enter estimated bills from other sources of expenditure upon the statement, why make the exception in the case of audit fees? It seems that there should be an item representing such fees on the balance sheet, even if an estimate of the probable amount is the best that can be done. In this way the banker will know just what obligations are outstanding.

Unclaimed Dividends.—Another item appearing under "other liabilities" needs careful scrutiny, and that is un-

claimed dividends. If the management of a corporation is efficient in its relations with its stockholders, it will have a follow-up system that will keep this item exceedingly small, by reason of the fact that addresses will be up to date, and all dividends paid to their rightful owners. When this item is shown to be of any consequence, the banker makes an examination for several purposes.

1. To see whether all unclaimed dividends have been credited to the proper parties.
2. To learn whether stockholders claiming unclaimed dividends are so entitled to them.
3. To ascertain if any payments have been made in currency and charged to this account, especially if dividends have been unclaimed several years.
4. To see if receipts paid into unclaimed dividends account can be produced.

If the management conducts the details of its business accurately and properly, they will be able satisfactorily to answer these questions and explain to the banker what he wishes to know about this item.

Certificate and Coupons Not Redeemed.—In some lines of business it is customary to sell special certificates and coupons, to be surrendered when merchandise or commodities or articles are purchased. A restaurant occasionally sells meal tickets for which the proprietor is liable. A dry goods store may issue stamps or certificates entitling customers to cash discounts, and other arrangements may be made which cast upon a company an uncertain liability which yet must be taken into consideration. These are questions a banker might ask, depending upon the nature of the certificates or coupons and the plan:

1. Do stubs check with amounts shown issued?
2. Do entries representing deliveries of merchandise for which certificates have been issued check with the stubs?

3. Has the total liability under the plan been anticipated, and will there be funds available to take care of this liability?

Containers.—Where containers, bottles, barrels, and the like are billed to customers greater than their actual value in use, with provisions for refunds to be made upon their return, a liability should be shown for the amount the actual liability exceeds that billed, and the banker will judge accordingly. The question of depreciation might arise in instances of this kind, and whether this was taken care of in making the rebates. In some cases these might add to the liability, making a larger amount necessary to be set aside.

Reserve Accounts.—Every company which is looked upon as a high-grade credit risk, and whose obligations are considered choice, makes it a practice to set up reserves against contingencies, and to write off as soon as possible all losses and reductions in asset values. Indeed, the conservative building up of reserves and relative efficiency of the working capital are probably two of the most significant features of companies whose unsecured obligations and securities have reached the plane of a first-class unsecured risk, and of a high-grade investment.

On the balance sheet of corporations there are several kinds of items found under the general classification of reserves. Among these a few of the most common are:

1. Valuation reserves, such as reserves for bad debts and for depreciation of machinery. Ordinarily they are properly shown as deductions from the assets to which they pertain.
2. Reserves to set up estimated liabilities, where the actual amount of liability is not known, but for which some provision must be made.
3. There are reserves which represent surplus which has been set aside for a certain length of time for a special

purpose. Since such reserves will later be carried back to surplus, they may be considered as part of it, and consequently a part of the proprietorship of the business. Perhaps the reserve of this kind which is of the most frequent occurrence is the "Reserve for Sinking Fund," or for some special working capital purpose.[7]

4. Surplus and secret reserves which are to allow for underestimation of assets or over-stating of liabilities, creating a margin. Such reserves as the present one are looked upon with suspicion by bankers, who find that they are used as a cloak to conceal shady operations for personal gain, and to deceive bankers and investors. Such amounts should be included in the regular surplus account.

Often there are heavy reserves for taxes, for dividends, and the banker, to check the reserves, must compare each with the liability in question, which the reserve is to offset.

In analyzing the reserve for taxes, the banker wants to know whether the amount has been figured properly and accurately. The borrower must also be prepared for any future liability which might arise over tax liability. Past years' assessments are sometimes asked to be checked up in the interests of the borrower, who sometimes in conversation with his banker or lawyer has been found to have paid too much in taxes, and may be in a position to recover from the government. To fail to prepare for state and government taxes is often so serious an error that a corporation is forced practically into liquidation due to the drain on its working capital to meet a heavy tax payment, for which it was not prepared.

In Figure 17, the statement of a lumber company is shown, on which appear reserves for medical services, for bonuses, and for depreciation $107,912.20. The thoughtful banker will want to know what the reserves set up cover, and under the last one, for depreciation, the banker will want to know the basis upon

[7] James O. McKinsey, Bookkeeping and Accounting, pp. 772-773.

which the depreciation was figured, and will then judge whether the item is correct or out of line.[8] The fact that the reserve is equal to one-half the amount entered on the statement under lumber, logs, and merchandise, might make the banker curious to know why such a substantial reserve was necessary.

Contingent Liabilities.—As far as possible the banker tries to anticipate all the contingent liabilities, but this is not

LUMBER MANUFACTURER

July 31, 1920

ASSETS

Cash	$ 20,926.31	
Accounts receivable	106,427.91	
Lumber, logs, and merchandise	193,148.47	
		$ 320,502.69
Timber	$1,244,504.65	
Plant and property	335,883.97	
Prepaid interest and insurance	5,821.84	
Deferred operating charges	8,120.34	1,594,330.80
		$1,914,833.49

LIABILITIES

Notes payable	$ 228,000.00	
Accounts payable	16,969.86	
Reserve for medical services	1,506.61	
Reserve for wage bonus	221.88	
		$ 246,698.35
Reserve for depreciation	$ 107,912.20	
Capital stock	1,000,000.00	
Surplus	560,222.94	1,668,135.14
		$1,914,833.49

Figure 17. Balance Sheet Showing Several Types of Reserves

always an easy thing to do, especially when the borrower does not himself know just what they will eventually amount to. They may consist of claims contested by a client, amounts due the government on taxes contingent upon certain conditions, unfilled contracts, and commitments on purchases under contract and paper discounted and other items.

[8] See McKinsey, pp. 772-773.

Because contingent liabilities have been known to turn into direct liabilities with disastrous results, it is only natural that bankers scan the balance sheet for these items, and try to learn as far as possible the company's liability under them. A corporation may owe only a small amount unsecured to banks, but if it has a large amount in contingent liabilities outstanding, it may ultimately be in danger, because of the unexpected transformation of contingent liabilities into direct liabilities and the consequent difficulty in meeting the obligations.

The importance of this item was well illustrated in the case of the Columbia Graphophone Company, which some time ago went into receiver's hands. The management of the concern, in a burst of enthusiasm in 1919 and 1920, made large forward contracts for materials and parts. For a long time after prices began to decline and business to fall off, this company was forced to continue to buy, and to borrow money with which to make payments. Gradually all the contingent liabilities became bank loans, and the merchandise increased in quantity but decreased in value.[9]

In Figure 18 is a comparative condensed balance sheet which pictures dramatically the extent of the loss sustained by the Columbia Graphophone Company when their contingent liabilities turned into direct obligations. It will be noted that in 1922 the deficit was $21,903,487. The surplus and reserves were used up by the end of 1920, and by 1922 it is noted that current liabilities exceeded current assets, a very deplorable situation which had to be adjusted.

From what has already been said it is quite evident that a borrower should exercise caution to see that full information is shown on the balance sheet as to all contingent liabilities. Such contingent liabilities as notes receivable discounted, accounts receivable sold, and also suits pending which may result in judgments against the firm or corporation, should be set forth clearly, with explanatory footnotes wherever detailed information is necessary to make the meaning clear.

[9] Henry S. Sturgis, Investments, pp. 89-90.

COMPARATIVE CONDENSED BALANCE SHEET, AS OF DEC. 31

ASSETS:	1922	1921	1920	1919	1918	†1917
Patents, goodwill	$ 1,000,000	$ 1,000,000	$ 1,013,720	$ 1,000,000	$ 1,000,000	$ 1,000,000
Plants, etc.	4,126,574	4,657,984	4,841,964	5,089,674	3,994,446	4,295,931
Inventory	7,066,798	14,218,925	23,236,574	9,516,620	7,257,737	7,874,521
Investments	1,225,000	1,225,001	2,146,351	695,000	695,000	686,635
Accts. and bills receivable	4,818,672	5,909,070	6,124,620	6,731,578	3,347,551	3,726,321
Cash	1,961,509	3,283,071	5,553,078	3,221,086	3,496,325	1,377,965
Advances	3,429,675	3,433,327	2,789,634	.....	.....	.....
Other assets	89,507	131,129	732,748	233,136	140,771	119,055
Deficit	21,903,487	14,579,882	.....	.....	.....	.....
Total	$45,621,222	$48,438,389	$46,438,689	$26,487,094	$19,931,830	$19,080,428
LIABILITIES:						
Common stock (stated value)	$12,966,512	$12,966,512	$12,902,239	$ 7,083,311	$ 4,540,362	$ 2,500,000
Preferred stock	9,642,572	9,642,572	9,883,731	10,584,841	3,571,450	5,186,685
Funded debt	6,000,000	6,000,000	6,000,000	.....	4,436,800	4,436,800
Mortgage payable	250,000	250,000	250,000	250,000	20,000	.....
Cur. accts., bills payable, etc.	16,414,790	16,901,321	16,378,195	5,686,872	4,896,240	4,768,765
Am. Graph. stock	.....	.....	4,935	17,525	70,616	.....
Reserves	347,348	2,677,984	.....	.....	.....	.....
Surplus and reserves	.....	.....	1,019,589	2,864,545	2,396,362	2,188,178
Total	$45,621,222	$48,438,389	$46,438,689	$26,487,094	$19,931,830	$19,080,428

† American Graphophone Co., thereafter Columbia Graphophone Mfg. Co

COMPARATIVE STATEMENT OF WORKING CAPITAL, AS OF DEC. 31

	1922	1921	1920	1919	1918	1917
Current assets	$13,846,979	$23,411,066	$34,914,272	$19,469,283	$14,101,613	$12,978,807
Current liabilities	16,414,790	16,901,321	16,378,195	5,686,872	4,896,240	4,768,765
Net current assets (d)	$ 2,567,811	$ 6,509,745	$18,536,077	$13,782,411	$ 9,205,373	$ 8,210,042
Ratio	**0.84**	**1.39**	**2.13**	**3.42**	**2.88**	**2.72**

Figure 18. Balance Sheet and Statement of Working Capital of the Columbia Graphophone Co.

Capital Liabilities.—The statement of capital liabilities quite naturally discloses the fixed charges with which a company is burdened. The capital of a corporation may be set forth in three ways:

1. Capital stock outstanding
2. The accumulated surplus
3. Reserves which represent appropriated surplus.

Different classes of stock should be shown as different items, such as 1st preferred, 2nd preferred, common, etc., indicating their positions in the financial structure. In analyzing the stock structure the banker does the following:

1. He examines, when necessary, certificates of incorporation to ascertain the amount of capital stock authorized, and checks this amount with that appearing in the statement.

2. He looks for any dividend accumulation in preference stocks. This is important from a loaning standpoint as it reflects on what the present or prospective stockholders may expect as to future dividends. If the financial outlook is clouded with heavy back payments to be met, the bank would naturally not be so anxious to extend accommodations, and would want to analyze the situation to see whether the condition was sound enough to warrant confidence, or whether there was a reorganization and possible loss in sight.

3. Special stipulations are important in relation to stock as well as to mortgages and bonds. The banker wants to know how the terms have been lived up to. Sometimes a specific ratio of current assets to current liabilities is to be maintained. Again, there may be a stipulation which provides that no dividends shall be paid on the common stock which shall reduce surplus below a certain amount.

4. The banker only corresponds with stockholders, and checks back amounts outstanding with stubs in the corporation certificate book when drastic measures are necessary to clear

up a badly tangled financial situation, or when reorganization is contemplated, or consolidation or liquidation are in view.

5. When stock is sold at a premium the banker wants to know into what account the proceeds went—whether carried as capital surplus or whether entered into the regular stock account. It might be asked also whether such surplus was used to pay regular cash dividends. If such is the case, the borrower would be open to criticism, as dividends should be declared only out of earned surplus.

6. The ratio between stocks and bonds is carefully determined. If the stock is small compared to other outstanding securities, as earnings grow they will mount fast on the common shares, but in bad times the per share earnings will fall as quickly. Bankers thus study the relation between the obligations, and watch the effect market conditions have on the stocks, for, as Henry F. Sturgis says, "such stocks are violent movers, and the equity behind the bonds is a variable factor of safety."

7. Individual deposits considered as capital are invariably looked upon by the banker with suspicion. This is because in case of financial difficulty those putting up the money have a strong tendency to pull out what they have advanced, leaving the company and the hopeful bankers to "hold the bag." The question always arises: Who are the individuals advancing funds used as capital? How long will it be left in the company? What were the agreements made for paying interest, and how much? In case of trouble can they call their loans, or will notice have to be given? If the individual deposits represent funds loaned the company by officers or employes, will such individuals, by reason of their close connection with the company's affairs, in the event of financial hazard, take advantage of their position to the detriment of the bankers and stockholders?

Regarding the previous discussion, the statement in Figure 19 represents a company which has on its balance sheet some

CORPORATION WHOLESALE DRY GOODS COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	12/31/25	12/31/26
Quick Assets	2,115,935	2,110,245
Current Liabilities	805,714	1,000,795
Ratio Q. A. to Liabilities	2.62 to 1	2.11 to 1
Surplus Quick Assets	1,310,221	1,109,450
Other Assets	41,795	43,329
Total Assets Less Current Liabilities	1,352,016	1,152,779
Less Mortgages and Reserves	472,164	272,503
Net Worth	879,852	880,276
Capital—Preferred	651,500	651,500
Capital—Common	228,352	228,776
Surplus	879,852	880,276
Total Sales	3,500,000	3,600,000
Net Profit or Loss		
Dividends Paid		
Chg'd off, depreciation and bad debts		
Carried to Surplus		
QUICK ASSETS:		
Cash on hand and in bank	71,187	55,783
Notes Receivable	6,670	53,073
Trade or Bank Acceptances		
Accounts Receivable	907,794	856,981
Mdse. finished	975,871	988,995
Mdse. unfinished		
Raw Material		
Listed Stocks and Bonds	154,412	155,412
OTHER ASSETS:		
Real Est. Plant, etc		
Machinery and Tools	23,545	28,708
Goodwill, Patents, Patterns, etc		
Due from Officers, etc	12,585	13,105
Unlisted Stocks and Bonds		
Deferred Charges	5,665	1,514
CURRENT LIABILITIES:		
Notes Payable	410,000	620,000
Trade or Bank Acceptances		2,572
Accounts Payable	53,475	86,247
Individual's Deposits, considered as Capital	319,605	291,975
	22,634	
OTHER LIABILITIES:		
Mortgages		
Reserve Accounts	472,164	272,503

Figure 19. A Statement Showing Excessive Amounts in "Individual's Deposits."

$300,000 in individual deposits used or considered as capital, and upon analysis it appears that this is equal to nearly 50% of the capital stock of the company. This is a considerable amount, sufficient, in fact, to cause serious financial embarrassment were the funds shown withdrawn from the business.

Dividends.—Some funded obligations define the net income from which dividends are to be paid as the balance after deducting certain expenses and depreciation, the rate of depreciation being set forth. It is essential to know what the corporate board of director's minute book stipulates in the way of dividends, the rate, payment and amount, and whether or not they have been declared in observance of legal requirements. Too liberal a policy in the matter of dividend payments is considered by bankers generally, to be objectionable, because, while it is realized that a company does not wish to shake public confidence by omitting dividends in the lean or deficit years, experience has shown that a conservative policy is essential to continued substantial progress. They encourage frankness in dealing with stockholders rather than the policy of sacrificing in dividends funds necessary to continued operation, and which are better sowed back into the company to tide it over periods of stringency.

Stock Subscriptions To Be Collected.—Sometimes there appears an item in the statement of stock subscriptions to be collected. Such items require explanation, and give rise to the following questions: Where are the subscriptions to be collected? What is the agreement made for payment on subscriptions? Are they being lived up to? Are any subscriptions overdue? Can the debtors pay up on the amounts falling due? These matters require investigation, inasmuch as experience indicates that it is one thing to have stock subscriptions paid in, and another to have them to be collected. Under adverse conditions, or sudden changes in financial conditions, the latter

problem often arises, and it is not always easy to bring the payments in, and for this reason the banker wants the particulars.

No-Par Value Stock.—When the borrower carries no-par value stock on his statement, the question might come up as to how the amount was set up in the balance sheet. The important consideration is whether or not the amount is carried in accordance with the values authorized by the directors, and in harmony with the laws of the state in which the corporation is organized. Caution should be exercised that the values put into the statement for such stocks be correct and properly presented.

Surplus.—Closely related to the foregoing, and of primary importance to the banker and those to whom he lends, is the question of surplus. Ordinarily the term refers to earned surplus, amounts available for dividends. There is also appropriated surplus, representing funds set aside for a specific purpose which is often shown on the statement under the heading "reserves." There is also capital surplus arising from the following:

1. Sale of stock at a premium.
2. Gifts.
3. Sale of capital assets at a profit.
4. Increases in asset values through re-appraisals.
5. Capital stock contributed by stockholders with issuance of additional stock.
6. An excess of assets over liabilities and capital stock at the time of the incorporation of the company.

The two last named are "paid-in surplus." As before stated no dividends should be paid from balances in capital surplus account, as such a practice is frowned upon by accountants and conservative bankers.

Earned Surplus.—As related to the question of earnings, surplus is significant. The question the credit man is anxious

to have answered is: What disposition is made of the earnings? Are they all paid out in dividends, or is a reasonable amount put back into the business? If the owners do not have sufficient confidence to reinvest some of their profits in the business, it is sometimes a very serious question whether a bank is justified in advancing even temporary capital. Bankers generally are of the opinion that it should be the aim of every concern to build up a strong reserve from net earnings not only to be in a position in the event of bad times, but to take advantage of the expansion which is the reward of constructive and forceful management.

When a surplus has been built up from earnings, the question might be asked: Where has the surplus been placed? How have the reinvested earnings been spent? Have they actually strengthened the position of the borrower through wise investment and expansion, or has there been a wasteful use of the funds, with no apparent return in increased volume of business? Have the earnings been put back into equipment plant and real estate in the form of fixed assets, or have they gone to increase working capital?

It is also wise to watch carefully the following usages and relations which are approved by experienced accountants and bankers:

1. Surplus should ordinarily contain only realized profits.
2. Anticipated profit items should not appear in the surplus; but if they do, a reserve should be set up against the assets showing such profits.
3. Entries should not be made in the statement as surplus which have not been duly authorized by the board of directors of the corporation.
4. Any sale of fixed assets resulting in special earnings should ordinarily be charged to the reserve account of such assets sold, unless such reserves have already been set up, and not charged to surplus. This is important, because at times

corporations have a tendency to cover losses sustained in operation through selling equipment and machinery not at the time in use, and to charge the amounts taken in to surplus. This puts the executives in an embarrassing position, and arouses suspicion on the part of alert bankers who realize that it is better to declare a loss than to create a fictitious surplus. Thus all unusual adjustments are noted in order to observe whether any attempt has been made to juggle assets, or unwise financial sacrifices made to cover losses. Bearing in mind that possibility, bankers note changes in the surplus account from the time of the organization of the company to the present date.

5. Sometimes items are unearthed which have come up after the books have been closed, and a statement has been rendered the banker. Such amounts may affect prior periods of operation, but they should not be charged to surplus as is occasionally done. It is better usage to enter such items with an explanation on the statement under a separate heading, so that they will not perplex the banker who is analyzing the financial condition of the company.

Although it is important for a company to build up a surplus and although those borrowers who "bleed" their concerns each year and thereby stunt their growth are not looked upon favorably, it is also a sign of weakness to have a surplus disproportionately large. Not only is control likely to be centered in a few hands, perhaps for personal reasons, but there is always the possibility that if the cash position is strong, extra dividends may at any time be declared out of surplus, thereby reducing the current ratio. Because such a contingency might prove awkward to the banker, it is customary for banks to find as definitely as possible just how the borrower plans to "administer" his surplus in the future, and then to draw their own conclusions and act accordingly.

6. Lastly, what of those changes affecting capital assets, and those which increase or decrease income? The question the

banker is interested in in this connection is: How much larger is the net income at the end of the period increased, as compared with the income at the beginning of the period, and is this increase properly reflected in the balance sheet? If the borrower eliminates dividends declared, if any, and special surplus adjustments, he will find that the actual increase in surplus for the period is represented by the amount of the net income for the period.

CHAPTER XII

COMPARATIVE STATEMENT ANALYSIS IN JUDGING COMMERCIAL LOANS

Importance of Comparative Statements.—Credit risks are projected into the future, and when a commercial bank loan matures, when the ability to make the actual payment is to be tested, the all important question arises: What now is the financial condition of the borrower? To grant credit is to presage future conditions affecting a credit risk. At the time the balance sheet of a company is presented for consideration for a loan, conditions may be favorable, but swings in commodity and goods prices, and an adverse movement in trade conditions may change the situation, and what was once a good risk, may become a poor one through circumstances of operation. Just as industrial conditions constantly change, so, too, do the affairs of a commercial enterprise. It is important for the banker to know, therefore, what has taken place since the company's financial condition was last reviewed? The balance sheet represents only a static condition of affairs. It mirrors only the results as existing upon a specific date, and because this is true, it alone is an inadequate means of measuring a company's financial progress. Experienced bankers find that single statements are not enough. Reliance on a simple balance sheet as a basis for analyzing a credit risk proves unsatisfactory from many angles. Single reports do not present cumulative information in all respects, and for this reason often tell only half the truth. The balance sheet is all right, so far as it goes, but it does not go far enough.

Every banker seeks an answer to several questions when

trying to establish a commercial risk. It is not enough for him to know whether the debtor will pay, and will pay when due, as answered on the basis of his past and present achievement, but also, will he be able to pay? This is to be answered on the past phases of the business cycle, in the light of present and probably future stages, as affecting the risk.

In order to be able to answer these questions satisfactorily, the banker has had to establish a more composite yardstick than the limited and rudimentary balance sheet as a means of judging financial progress. He has in fact found that the only safe procedure lies in securing comparative statements of condition covering several fiscal periods, thereby insuring more possibilities from an analysis standpoint, and providing sufficient data to give a well-rounded picture of the risk.

What the Banker Wants in Comparative Balance Sheets. —Because of the rapid changes in general business conditions affecting particular industries, and because of possible internal changes which are apt to occur in an enterprise, due to changes in management policies and personnel, it is important that the reports which are submitted by the borrower for comparative purposes meet certain requirements. Some of the more important of these are as follows:

1. The banker or lender must be given possession of a sufficient number of reports, covering five years' operations, if possible.
2. The statements presented should embrace two or more cycle periods, preferably, although one complete cycle may suffice.
3. The reports sent in should be selected upon the basis of separate phases, including depression, revival, prosperity, and liquidation in the business cycle.

The foregoing precautions insure the lender, compiling the composite balance sheet, a cross-section of the progress of the company under consideration, and make for a balanced analysis,

FEDERAL RESERVE BANK OF CHICAGO
COMPARISON OF STATEMENTS

ASSET			
CASH			
NOTES RECEIVABLE			
ACCOUNTS RECEIVABLE			
NOTES OR ACCTS. REC. (PARTNERS OR OFFICERS)			
ADVANCES			
TRADE ACCEPTANCES			
MERCHANDISE FINISHED			
MERCHANDISE UNFINISHED			
RAW MATERIAL			
U. S. SECURITIES			
STOCKS, BONDS AND INVESTMENTS			
REAL ESTATE AND BUILDINGS			
MACHINERY AND FIXTURES			
UNEARNED INS., DISCOUNT AND INT.			
GOOD WILL, PATENTS AND PATTERNS			
SUPPLIES			
TREASURY STOCK			
TOTAL			
LIABILITIES			
NOTES PAYABLE, MERCHANDISE			
NOTES PAYABLE, BORROWED MONEY			
OTHER NOTES PAYABLE			
NOTES OR ACCTS. PAY. (PARTNERS OR OFFICERS)			
OPEN ACCOUNTS			
CHATTEL MORTGAGES			
LABOR AND SALARIES ACCOUNT			
DEPOSITS OF MONEY WITH US			
RESERVE FOR TAXES			
BOND INTEREST			
BONDED DEBT			
MORTGAGES OR LIENS ON RL. EST.			
RESERVES			
DEPRECIATION RL. EST. AND BLDGS.			
DEPRECIATION EQUIPMENT			
CAPITAL (PREFERRED STOCK)			
CAPITAL (COMMON STOCK)			
SURPLUS AND UNDIVIDED PROFITS			
NET WORTH (IF FIRM)			
TOTAL			
TOTAL QUICK ASSETS			
CURRENT LIABILITIES			
EXCESS QUICK			
RATIO QUICK TO CURRENT			
CONTINGENT LIABILITIES			
SALES			
NET EARNINGS			
DIVIDENDS OR WITHDRAWALS			
CHARGED OFF			
ADDED TO SURPLUS			
TOTAL			

Figure 20. Federal Reserve Bank Statement Form

reflecting the ability of the concern to weather all kinds of circumstances, as revealed from past and present operations.

By way of illustrating the use made of comparative balance sheets by banks, there are presented herewith two forms, both having 12 columns, making it possible to show monthly or yearly comparisons. Space did not permit showing all the rulings. The first, shown in Figure 20, includes 49 items, and is the one sent out by a Federal Reserve Bank to fill requests of member banks who wish a form in making up their own reports. The second form, shown in Figure 21, is a condensed comparison of statements in use by a middle western bank, and contains only 37 items. It is used by the bank in presenting borrowing corporation figures before the discount committee for consideration, and is more of a brief summary of items than that of the Federal Reserve Bank, which is more complete, both having room enough on the form to include 12 years' operations, or if desired, 12 months' operations.

It is a matter of experience that the examination and analysis of two statements individually, and the items contained in them, cannot be done efficiently when the two statements are shown separately. Accordingly, a comparative statement similar to those shown in Figures 20 and 21 is used advantageously that all the data, as of both dates, are brought together in one place and so set out as to make the data easily read and comprehended. This method locates definitely all the assets and liability changes. The statement summarizes the result of the deductions made and shows the net increase or decrease of the second date as compared to the first date. Ordinarily, the net increase would represent net profit and the net decrease, net loss. But the causes making for the result are readily discernible only through a comprehensive analysis, set forth below.

Value of Comparative Analysis to Borrower and Banker. —Up to the present time the banking profession as a whole has not gone very extensively into the field of comparative analysis

CORPORATION WHOLESALE GROCER COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	1/1/24	12/31/24	6/30/25
Quick Assets	975,469	784,252	821,190
Current Liabilities	404,320	158,585	210,948
Ratio Q. A. to Liabilities	2.41 to 1	4.93 to 1	3.89 to 1
Surplus Quick Assets	571,149	625,667	610,242
Other Assets	221,551	216,175	229,063
Total Assets Less Current Liabilities	792,700	841,842	839,305
Less Mortgages and Reserves			
Net Worth	792,700	841,842	839,305
Capital—Preferred		346,200	
Capital—Common		543,100	
Surplus		47,458	
Total Sales			1,750,000
Net Profit or Loss			
Dividends Paid			
Chg'd off, depreciation and bad debts			
Carried to Surplus			
QUICK ASSETS:			
Cash on hand and in bank	8,705	28,392	17,893
Notes Receivable	933	4,100	6,714
Trade or Bank Acceptances			
Accounts Receivable	264,138	263,042	313,142
Mdse. finished	688,951	508,717	474,726
Mdse. unfinished			
Raw Material			
Listed Stocks and Bonds	1,550		
OTHER ASSETS:			
Real Est. Plant, etc	168,904	178,213	181,191
Machinery and Tools			
Goodwill, Patents, Patterns, etc			
Due from Officers, etc			
Unlisted Stocks and Bonds	45,880	31,883	41,647
Deferred Charges	6,767	6,129	6,225
CURRENT LIABILITIES:			
Notes Payable	385,270	116,500	171,500
Trade or Bank Acceptances			
Accounts Payable	19,050	36,291	31,164
Individual's Deposits			
Taxes		5,793	8,284
OTHER LIABILITIES:			
Mortgages			
Reserve Accounts			

Figure 21. Corporation Comparison of Statements Form.

in making unsecured commercial loans. It was not until bankers began to recognize, through study and experience, that the various industries have quite different financial characteristics, that they realized the importance of comparative analysis as a means of establishing significant fiscal relationships.

The study of comparisons is broad, and has infinite possibilities for the thinking borrower and banker. Not only can the comparisons be made relating to the balance sheet position in a particular company over a period of years, and of the earnings of the company as reflected in such comparisons, but valuable analyses can be made by picturing and comparing the relationship of one specific company with others in the same line of business activity.

In this discussion there will be taken up, first, the analysis by comparison, as applied to one enterprise only; then the value of comparison in relation to an entire industry.

A New Method of Balance Sheet Analysis.—In order to appreciate the importance of comparative analysis the reader must realize that the changes that came about in the financial affairs of industry throughout the war and post-war years created new standards, new fiscal relationships, which had a direct bearing on operations. The banker had to orient himself in these newly established conditions, and found that comparative analysis was the way out.

The old "rule-of-thumb," two for one ratio, as a means of gauging the financial status of a company in the face of war-time prices and war-time demands on industry, which brought about a tremendous expansion in the financial structure of business, proved inadequate. When prices went up and volume increased, more capital was required to carry inventories, and customers' accounts. With the increased physical volume, production facilities were enlarged in most industries.

Naturally, when the business readjustment came and both volume and prices declined severely, companies faced the prob-

RATIOS

Machinery Mfrs.	1913	1914	1915	1916	1917	1918	1919	1920	1921	1922	1923	1924
Lanston Monotype Machine Co.	3.38	3.24	3.41	3.58	2.60	2.55	2.68	2.81	2.38	2.44	2.58	2.98
Mergenthaler Lino ype Co.	57.58	1,649.03	587.19	220.98	21.83	7.58	9.72	2.51	3.47	6.21	5.12	6.27
Ingersoll-Rand Co.	7.57	10.29	7.82	6.11	3.52	3.08	6.95	6.28	21.62	6.58	11.68	13.76
Otis Elevator Co.	3.88	3.27	2.38	1.58	1.58	1.99	2.86	3.97	3.75	7.53	6.65	5.75
American Can Co.	8.31	9.21	6.38	4.82	2.33	2.14	4.31	2.91	5.47	5.05	5.05	5.34
Continental Can Co., Inc.	5.50	8.08	2.60	2.48	2.17	1.45	2.29	1.40	1.74	4.96	6.11	9.74
Nat'onal Sew'ng Machine Co.	.....	7.32	13.18	.....	.....	83.25	72.20	7.44	7.53	3.75	4.20	4.92
Underwood Typewriter Co.	5.86	4.72	4.63	6.69	3.80	3.28	3.34	4.62	3.30	3.92	5.73	4.17
Remington Typewriter Co	2.37	1.93	1.92	11.87	8.13	7.56	4.82	4.00	3.93	7.86	7.07	6.61
The Bucyrus Co.	4.56	5.89	7.17	4.99	3.13	2.51	4.21	3.27	5.61	5.13	4.15	3.74
National Enameling & Stamping Co.	3.39	3.75	3.22	5.16	5.13	4.75	4.11	6.50	6.46	5.58	2.37	3.43
Computing-Tabulating-Recording Co.	3.24	4.00	4.71	3.62	3.07	3.06	2.81	2.16	2.19	2.58	5.50	5.07
Chicago Pneumatic Tool Co.	6.33	5.89	4.25	2.92	2.43	3.89	2.49	5.29	6.89	4.85	4.91	4.20
Allis-Chalmers Co.	12.70	16.14	8.74	8.12	3.64	2.68	4.59	4.61	7.17	7.27	6.11	3.90
American Radiator Co.	6.06	8.26	8.58	9.13	7.89	5.62	2.76	9.06	8.38	7.33	6.83	5.21
United Shoe Machinery Co.	67.55	35.66	17.61	34.15	11.20	10.02	6.65	3.86	3.24	3.24	3.74	3.57
Reece Button-Hole Machine Co.	149.33	195.60	214.00	149.57	214.80	282.00	277.25	175.17	534.00	.....	.....	.....
Reed-Prentice Co.	5.99	4.40	3.40	2.57	2.36	3.63	5.36	7.98	7.88	3.38	2.61	5.65
Niles-Bement-Pond Co.	.....	4.25	2.80	2.83	2.32	2.15	3.61	4.72	5.14	3.55	3.75	4.82
Pneumatic Scale Co.	.....	2.30	3.96	3.14	2.38	4.31	4.22	1.92	.93	.....	.....	.....
E. W. Bliss Co.	.....	.....	1.61	3.13	2.00	1.86	2.55	1.33	3.02	10.02	15.77	2.67
Worthington Pump & Machine Corp.	.....	.....	12.45	5.23	3.77	2.81	4.02	4.77	5.27	4.78	10.16	15.47
National Acme Co.	.....	.....	.....	.....	4.73	3.19	3.87	2.15	5.60	5.05	6.27	5.38
Bishop, Babcock, Becker Co.	.....	.....	.....	.....	6.27	2.51	2.87	2.48	4.39	3.41	1.67	1.74

Figure 22. Table Showing Ratio of Current Assets to Current Liabilities

lem of readjusting the financial structure to fit the new business conditions. As business activities contracted and price levels became lower, effective financial management required similar contraction in the financial structure of business. In most concerns, entirely new relationships, ratios, and turnovers appeared—some favorable, some unfavorable.

It is obvious that under such divergent forces there should be a variation in the existing standards and relationships between the items and ratios found in the financial statements. In Figure 22 is a table prepared by Babson's Statistical Bureau, which presents the different ratios of current assets to current liabilities, as existing in 17 different companies over a nine-year period, from various parts of the country. It will be seen that there is a wide range in these ratios, which would indicate that financial standards vary in different industries as do working capital requirements, and that the banker, to measure financial achievement, must of necessity seek more comprehensive analysis to form an accurate judgment of the risk.

New Comparative Balance Sheet Analysis.—To cope with this problem of finding a workable criterion for measuring financial progress and soundness, the Robert Morris Associates, a group of financial credit men, developed a new method of balance sheet analysis. It requires only the sales for the year, in addition to the comparative balance sheet; and takes into consideration eight ratios, given below, and thereby insures a truly informative picture of a company's financial condition.

Eight Ratios and Relative Weight Given to Each

	%
Current ratio	25
Merchandise to receivables	5
Net worth to non-current assets	10
Sales to receivables	15
Sales to merchandise	15
Sales to net worth	5
Worth to total debt	20
Sales to fixed assets	5
Total	100

The much simplified balance sheet of a successful company for the years 1921-1924, inclusive, which is shown in Figure 23, will be used to indicate the new method of balance sheet analysis.

"Current Ratio.—The current ratio of current assets to current liabilities has been used for so long a time that no further explanation is needed. The current ratio of the A. B. C. Company shows a steady improvement in the years 1921 to 1924, to wit:

1921, 333%; 1922, 450%; 1923, 524%; average 1921-1923, inclusive, about 415%; 1924, 545%."

"Merchandise to Receivables.—The ratio of merchandise to receivables, the least significant of the new factors in balance sheet analysis, is secured through dividing the total merchandise inventory by the total accounts and bills receivable resulting from the sales of merchandise. The resulting ratio gives the dollars of merchandise for every dollar of merchandise sales receivable, and indicates the extent to which a profit item has been reflected on the balance sheet through the conversion of inventory to sales. Inasmuch as the accounts receivable are light, the ratio means comparatively little to the A. B. C. Company. The ratio fluctuates from 235% in 1921 to 667% in 1922, and back again to 300% in 1923, and to 294% in 1924. The average for the years 1921-1923 inclusive is about 330%."

"Net Worth to Non-Current Assets.—Stockholders' contributions should be so used as to take care of plant equity and the cost of all other non-current assets and provide in addition something for working capital. How this has been accomplished may be ascertained through dividing the net worth of a company by its net non-current assets. This ratio for the A. B. C. Company is fairly constant, 153% in 1921, 136% in 1922, 146% in 1923; 145% is an average for years 1921-

BALANCE SHEET OF THE A. B. C. COMPANY

Assets:	1921	1922	1923	1924
Cash	$ 3,150,000	$ 2,200,000	$ 2,700,000	$ 3,050,000
Receivables	850,000	300,000	700,000	750,000
Merchandise Inventory	2,000,000	2,000,000	2,100,000	2,200,000
Current Assets	$ 6,000,000	$ 4,500,000	$ 5,500,000	$ 6,000,000
Non-Current Assets:				
Fixed Assets	5,750,000	6,650,000	7,225,000	7,500,000
Deferred Charges	250,000	350,000	275,000	250,000
Total Assets	$12,000,000	$11,500,000	$13,000,000	$13,750,000
Liabilities and Net Worth:				
Notes and Accounts Payable	$ 1,000,000	$ 600,000	$ 550,000	$ 450,000
Tax Reserve	800,000	400,000	500,000	650,000
Current Debt	$ 1,800,000	$ 1,000,000	$ 1,050,000	$ 1,100,000
Funded Debt	1,000,000	1,000,000	1,000,000	1,000,000
Total Debt	$ 2,800,000	$ 2,000,000	$ 2,050,000	$ 2,100,000
Capital Stock	7,500,000	7,500,000	8,500,000	7,500,000
Surplus	1,700,000	2,000,000	2,450,000	4,150,000
Total Liabilities and Net Worth	$12,000,000	$11,500,000	$13,000,000	$13,750,000
Sales	$16,000,000	$18,000,000	$22,000,000	$24,000,000

Figure 23. Specimen Illustrative Balance Sheet

1923, inclusive, and 150% in 1924, indicating that about the same proportion of net worth is being invested in plant and other non-current assets."

"Sales to Receivables.—The test of the freshness of accounts receivable lies in the relationship they bear to sales. A high turnover of receivables is just as desirable as a high turnover of merchandise. As the ratio of sales to receivables falls, the collection period increases until a state of stagnation occurs. Receivables with the A. B. C. Company are so small in comparison to sales that the ratio loses the significance which it ordinarily has for most companies for credit granting purposes. As a matter of fact, the ratio of sales to receivables for the A. B. C. Company is 1885% in 1921, 6000% in 1922, 3143% in 1923, about 3027% average for the years 1921-1923, inclusive and 3200% in 1924, giving a common figure of about 3000%."

"Sales to Merchandise.—It is most important for the credit grantor to know whether the applicant for a loan has much frozen merchandise. The test for this is the relationship that the sales bear to the merchandise. A truly accurate computation of turnover is secured by taking the sales at cost, divided by the average monthly inventory at cost; or the sales at retail, divided by the average monthly inventory at cost; or the sales at retail, divided by the average monthly inventory at retail. It must be borne in mind, however, that the ratios to be worked out in the new method of balance sheet analysis have only the balance sheet itself and the sales to work with. Therefore, the closest approximation of true turnover is secured by dividing sales by the merchandise at cost. Over a period of years this will give a fair comparison for a company and for an industry, it is believed by those promoting the new method of balance sheet analysis. The company under examination has a very high turnover of merchandise and a turnover

that shows steady improvement; it is 800% for 1921, 900% for 1922, 1048% for 1923, and 1090% for 1924. The average for the years 1921-1923 is about 918%."

"Sales to Net Worth.—The net investment as well as the accounts receivable and merchandise should show a desirable activity. Where earnings are steadily plowed back into the surplus of the company, it sometimes happens that it takes a great deal more investment to do the same amount of business, and that this additional capital could be more profitably employed elsewhere. On the other hand, where operations are unduly expanded, capital structure is sometimes expected to do more than can be accomplished reasonably and safely. The company under review shows a slow and healthy rise in the relationship of its sales to net worth: in 1921, 174%, in 1922, 190%, in 1923, 201%, and 1924, 206%. The average for the years 1921-1923 is about 189%."

"Worth to Total Debt.—A most important factor for credit granting purposes is to know to what extent a company is operating on its own capital and to what extent it is relying on outside assistance. As a matter of fact, in the new method of balance sheet analysis this ratio is given a rating of 20%, and it is considered next in importance to that of the current ratio. The ratio is secured by dividing the net worth by the total debt—both funded and current. The position of the A. B. C. Company shows constant improvement in this particular. Such ratio of worth to total debt was 328% in 1921, 475% in 1922, 534% in 1923, 555% in 1924. The average for the three years 1921-1923 is about 433%."

"Sales to Non-Current Assets.—Generally speaking, the earning capacity of the plant investment depends on the volume of goods it can produce and sell. Where this ratio, secured by dividing the net sales by the net total non-current assets, steadily falls and is accompanied by a similar falling

in the ratio of worth to non-current assets, the indications are that there has been an undue expansion of plant. In the company under review the improvement in this ratio is fairly steady: 266% in 1921, 257% in 1922, 293% in 1923 and 310% in 1924, about 273% during the three years 1921-1923 inclusive."

"Evaluating the Ratios.—The time will come, it is hoped, when sufficient experience will be available to establish indices by industries for the respective ratios included in the new method of balance sheet analysis, at which time all that will be necessary for the credit granting officer will be to compare the showing of an individual company with the norms established for the industry. Such information is not as yet available. In the meantime, reliance must be placed largely on the company's own history. In this way the record for a particular year will be compared with the average of the three to five previous years. For example, the A. B. C. Company has a current ratio for the year 1924 of 545%. Its average for the three previous years, 1921-1923 inclusive, is 415%. The ratio for 1924, 545% divided by the average for the three previous years, 415%; multiplied by 25% the weight of the ratio, gives a credit index of 33%. Working out the various other ratios in like manner gives results for the A. B. C. Company as shown below."

Summary of ratios

The respective ratios for the A. B. C. Company align themselves as follows:

	1921 Per Cent.	1922 Per Cent.	1923 Per Cent.	Average 1921–23 Per Cent.	1924 Per Cent.
Current Ratio	333	450	524	415	545
Merchandise to Receivables	235	667	300	330	294
Net worth to Non-Current Assets	153	136	146	145	150
Sales to Receivables	1885	6000	3143	3027	3200
Sales to Merchandise	800	900	1048	918	1090
Sales to Net Worth	174	190	201	189	206
Worth to Total Debt	328	475	534	433	555
Sales to Fixed Assets	266	257	293	273	310

RESULTS FOR THE A. B. C. COMPANY

	Weight Per Cent.	Average 1921–23 Per Cent.	1924 Per Cent.	Credit Index Per Cent.
Current Ratio	25	415	545	33*
Merchandise to Receivables	5	330	300	5
Net Worth to Non-Current Assets	10	145	150	10
Sales to Receivables	15	3027	3200	16
Sales to Merchandise	15	918	1090	18
Sales to Net Worth	5	189	206	5
Worth to Total Debt	20	433	555	26
Sales to Fixed Assets	5	273	310	6
Total	100			119

*Fractions omitted.

"The table shows 19% better results for the A. B. C. Company for the year 1924 in comparison with its average for the years 1921-1923."

"The new method of balance sheet analysis has come to stay. It gives a richer, truer, far more informative picture of a company's affairs than older methods. But it is not perfect. For its development is still required the experience of many companies and the play of thought of many minds."[1]

Comparative Analysis and the Statement of Application of Funds.—From the foregoing presentation of analytical comparative analysis the reader gains some appreciation of the value of ratio percentages as a means of judging financial strength and progress. In the statement of application of funds which will now be discussed, there is shown the increase or decrease in the amounts of the items appearing on the comparative balance sheet. This enables the student of finance to see just what disposition has been made of funds, and how the percentages discussed in the preceding sections actually work out in dollars and cents.

The application of funds statement, indeed, shows concisely the general financial changes, and indicates the practical effect of the financial policies which have been followed by the officers

[1] Monthly Bulletin, Ill. Manufacturers' Cost Assn., No. 56, Oct. 5, 1925.

of the company, and which have produced the results reflected in the financial ratios created, and the distribution of gains and losses. The advantage to the banker and borrower in a statement of application of funds lies in the fact that it is possible to review quickly the changes which have occurred over several fiscal periods without necessitating the comparing, individually, of the items on the comparative balance sheets.

Disposition Of Funds Invested in Business Disclosed.— If the management of a concern has been conservative, it will have built up its working capital so that the ratio of current assets to current liabilities will be adequate. The earnings will not have been paid out in dividends, to the exclusion of a desirable working capital ratio. Investment in plant extensions may claim too large a portion of the funds received, from operating profits alone. It is important to observe carefully the disposition of the funds obtained in order that the soundness of financial policies may be proved or disproved.

Current funds are obtained by any business from four principal sources—from stockholders, from lenders of money, from operating income, and from the conversion of fixed assets or assets not previously included under the heading of current funds. Funds derived from these sources may be applied to:

1. Increases in working capital.
2. Purchases of long-term investments.
3. Additions to plant and equipment.
4. Retirement of outstanding long-term indebtedness or capital stock.
5. Dividend payments.
6. Losses from operations.

Knowledge of accounting is not necessary to enable one to prepare a statement of application of funds, which, if not in all respects technically correct is near enough the mark for all practical purposes. In Figure 24 is shown the comparative

balance sheet of the X Company at December 31, 1924, and at June 30, 1925, in the shape ordinarily found in the files of the credit department. The increases and decreases in amounts are carried into the two right-hand columns. The total net increase or decrease of these columns should equal the net increase or decrease in assets, thus assuring clerical accuracy.

COMPARATIVE BALANCE SHEETS

ASSETS	Dec. 31, 1924	June 30, 1925	Increase	Decrease	Ref.
Cash on hand and in banks.	$ 50,000.00	$ 60,000.00	$10,000.00	.....	
Notes receivable.....	24,000.00	20,000.00	.....	$ 4,000.00	
Accounts receivable.....	155,000.00	159,000.00	4,000.00	.....	
Inventories.....	180,000.00	205,000.00	25,000.00	.....	
Prepaid expenses.....	16,000.00	14,000.00	.....	2,000.00	
Total current assets...	$425,000.00	$458,000.00	$39,000.00	$ 6,000.00	1
Investments.....	60,000.00	65,000.00	5,000.00	.....	2
Land.....	15,000.00	20,000.00	5,000.00	.....	3
Buildings.....	150,000.00	160,000.00	10,000.00	.....	4
Machinery and equipment	125,000.00	128,000.00	3,000.00	.....	5
Reserves for depreciation.	40,000.00	50,000.00	.....	10,000.00	6
Goodwill.....	50,000.00	50,000.00	.....	.....	
Total assets.....	$785,000.00	$831,000.00	$62,000.00	$16,000.00	
LIABILITIES AND NET WORTH					
Accounts payable.....	$ 55,500.00	$ 85,000.00	$29,500.00	.....	
Notes payable.....	100,000.00	80,000.00	.....	$20,000.00	
Accrued liabilities.....	80,000.00	60,000.00	.....	20,000.00	
Total current liabilities	$235,500.00	$225,000.00	$29,500.00	$40,000.00	7
Bonds outstanding.....	100,000.00	90,000.00	.....	10,000.00	8
Capital stock.....	350,000.00	375,000.00	25,000.00	.....	9
Surplus.....	99,500.00	141,000.00	41,500.00	.....	10
Total liabilities and net worth.....	$785,000.00	$831,000.00	$96,000.00	$50,000.00	

An analysis of the increase of $41,500.00 in the surplus account shows the following:

Surplus net profits for the six months of 1925.....	$56,500.00	11
Less—Dividends paid.....	15,000.00	12
Net, as above.....	$41,500.00	10

Figure 24. Comparative Balance Sheets of the X Co. Showing Increases and Decreases in Assets and Liabilities.

The increase or decrease in the net working capital is ascertained thus:

Increases in current assets	$39,000		1
Decreases in current assets	6,000	$33,000	1
Increases in current liabilities	$29,500		7
Decreases in current liabilities	40,000	10,500	7
Increase in net working capital		$43,500	(1)
			(7)

The application of funds statement may now be completed by summarizing the increases or decreases in financial position in a readable manner. The last form, shown in Figure 25, is suggestive, one intended as a supplement to the usual bank form on which the comparative balance sheets of a company appear. References do not need to be included, but are shown here to aid in tracing the increases and decreases for the first half of 1925 to the statements. Figures for the two other periods are assumed for illustrative purposes.

The increase of $10,000 in the depreciation reserves during the period has been shown as a fund received because the funds —a portion of which is now being called an operating expense —were distributed and accounted for as a fund applied in an earlier year.

From this form the following facts are brought to the banker's attention:

1. Earnings in the last two six months' periods; a loss in the first six months of 1924.
2. The loss was met principally by selling capital stock and investments and cutting down working capital.
3. Working capital was strengthened during the last six months by investing therein 48% of the funds received. In the previous six months' period the company also invested substantially in working capital 42%.
4. From 7% to 12% of all funds have been used to liquidate long-term indebtedness.
5. Dividends have been paid consistently—29% of the funds provided in the year 1924 were paid out in dividends.
6. The company invested 5% of its 1925 funds in securities for use in case of financial depression.
7. Plant additions apparently are not abnormal.

APPLICATION OF FUNDS STATEMENT

X Company
1282 Eighth Street
Chicago, Illinois

Dates	1924				1925	
	Jan. 1–June 30	%	July 1–Dec. 31	%	Jan. 1–June 30	%
FUNDS RECEIVED:						
Surplus net profits (11)	.....	..	$ 60,000.00	45	$56,500.00	62
Increase in depreciation reserves (6)	$11,000.00	14	12,000.00	9	10,000.00	11
Sales of own bonds	.....	..	50,000.00	38	.....	..
Sales of own stock (9)	10,000.00	12	10,000.00	7	25,000.00	27
Sales of investments	20,000.00	25	.....	..	.....	..
Sales of fixed assets	5,000.00	6	1,000.00	1	.....	..
Decreases in working capital	34,000.00	43	.....	..	.....	..
Totals	$80,000.00	100	$133,000.00	100	$91,500.00	100
WHICH WERE APPLIED THUS:						
Additions to plant and equipment (3) (4) (5)	$10,000.00	12	$ 3,000.00	3	$18,000.00	20
Invested in securities * (2)	.....	..	25,000.00	19	5,000.00	5
Dividends paid (12)	18,000.00	23	39,000.00	29	15,000.00	16
Increases in working capital (1) (7)	.....	..	56,000.00	42	43,500.00	48
Long-term indebtedness retired (8)	10,000.00	12	10,000.00	7	10,000.00	11
Operating net losses	42,000.00	53	.....	..	.....	..
Totals, as above	$80,000.00	100	$133,000.00	100	$91,500.00	100
Working capital ratio	1.75	..	2.21	..	2.04	..

Remarks: .....

* Not a temporary investment or otherwise a current asset.

Figure 25. Application of Funds Statement[2]

[2] By Paul W. Pettengill, C. P. A., Kohler, Pettengill & Co.

Value of Comparative Analysis of One Concern and the Industry as a Whole.—Much has already been said of the value of judging the future prospects of an enterprise by its financial achievements in the past and present through comparative analysis. While sound practice requires such intensive financial introspection, still, for the management of a corporation to limit its vision by always looking inward, is often as fatal as not looking at all. Every business, just like every individual, is a reflection of its environment. If the general conditions under which a business exists are unfavorable, how can substantial progress be expected? Suppose the raw materials used by the given corporation remain too high in price, and its finished goods remain too low in price year in and year out? The inevitable effect must be to wipe out the margin of profit, impair, first, the working capital, and then the physical plants of the corporation, and throw its very solvency into doubt.

With increasing competition under conditions of broadening markets for commodities, it is essential that a given concern take heed of those operating in the same line of business, and that comparative analysis be constructively carried forward beyond its own limited sphere of action. It is true that financial conditions of the same types of business vary according to location, and because of various causes resulting from the law of supply and demand, which are beyond the control of business management, no matter how shrewd. Still, a study of business statistics reveals the fact that there are certain financial principles and standards which may be adhered to advantageously by the typical concern in a particular industry. Allowing for the differences in working capital requirements, and other financial differences, there are yet, essential costs which cannot be overlooked. To stay in business a company has to meet these costs. Therefore, it is of particular importance for the management of a concern to know what the costs are for his entire industry, as well as to know what is the

financial structure required to make profitable operation possible.

Comparison As Related to the Profit and Loss Account.— Accountants and bankers find that the average business man does not know what things cost him. Indeed, the financial manager of a large box manufacturing company recently remarked that before the consolidation, now in force, he used to wonder how some of his competitors could afford to take contracts at their own bids. After the consolidation he discovered that these companies never knew even approximately the cost of manufacturing their goods, and often took contracts at an inevitable loss, which simply had to be made good by large profits on other contracts. This is typical of many concerns in our American business, particularly small ones. But careful analysis and comparison of figures with other firms in the same industry prove of the greatest value.

In order to eliminate useless "cut-throat" competition and to insure consistent progress in industry, much headway has been made in recent years by compiling cost figures relating to the different industries, which figures have been made public by the compilers for industrial use. Not alone are financial ratios worked out for the executives wishing to make use of them, but operating costs as well have been compiled, so that the cost of business, as pertaining to a particular industry, ceases to be guess-work. The Harvard Bureau of Business Research, the Federal Census Bureau, the Commissioner of Internal Revenue, and industrial groups in different types of industries have done excellent work in this direction, and the fruits of their labors have been of untold value to the thinking executives who are anxious to go forward on the most profitable and economical operating basis.

An examination of the situation through the years has convinced bankers and economists that the companies in the same line of business can profit greatly by pooling their operat-

ing cost figures. That is, the information regarding costs, inventories and other important data is sent into a central headquarters, where it is compiled collectively for the benefit of the participating members in the association.

Comparative Industrial Statistical Research Helpful.—The value of statistical research of this character in trade organization work is evidenced by the activities of many national organizations. Instead of groping in the dark, members of these associations, by virtue of this research, can not only stabilize their financial program, but can forecast the future trend of business in their industry to a degree of accuracy, the value of which cannot be measured.

Take, for example, the national institute devoted to fabricators of reinforcing steel, which is used in concrete construction projects. The institute referred to embraces 95% of the warehouses fabricating new billet reinforcing steel. Its members supply the secretary with confidential tonnage reports each month, which are analyzed and published, to the membership, in composite form.

These reports are divided into districts, with Pittsburgh, Chicago and Birmingham as centers, and show the following:

1. Tonnage sold during the month divided into 12 major classifications, such as roads, public buildings, residences, etc.
2. Stocks in warehouse on last day of month.
3. Normal stocks.
4. Tonnage shipped from warehouse during the month.
5. Tonnage shipped direct from mill during the month.
6. Unfilled orders on last day of month.

The table in Figure 26 showing stocks on hand in the three major districts, contrasted with normal stocks, will indicate the value of these statistics to the purchasing departments of the various members.

TOTAL TONNAGE OF BARS AND SPIRAL MATERIALS IN WAREHOUSES LAST DAY OF MONTH CONTRASTED WITH NORMAL STOCKS

Month 1925	Stocks Pittsburgh District	Normal	Stocks Chicago District	Normal	Stocks Birmingham District	Normal	Total Stocks	Total Normal	Surplus	Shortage
January	37,800	35,495	26,288	26,735	3,240	3,740	67,328	65,970	1,358	.....
February	42,915	36,645	29,498	26,564	3,261	3,736	75,674	66,945	8,729	.....
March	42,989	35,716	37,411	30,923	3,059	3,669	83,459	70,308	13,151	.....
April	54,796	44,566	44,537	36,147	5,241	5,098	104,574	85,811	18,763	.....
May	53,494	37,361	38,742	30,987	4,820	5,301	97,056	73,649	23,407	.....
June	44,118	36,440	28,054	24,838	4,439	5,301	76,611	66,579	10,032	.....
July	39,546	34,489	25,518	22,548	4,986	5,721	70,050	62,758	7,292	.....
August	36,956	35,289	22,930	23,618	6,093	5,621	65,979	64,528	1,451	.....
September	35,914	34,489	20,148	23,153	5,322	5,701	61,384	63,343	.....	1,959
October	33,263	33,650	19,775	22,707	7,429	6,300	60,467	62,657	.....	2,190
November	33,861	37,850	18,975	22,036	8,303	6,200	61,139	66,086	.....	4,947
December	29,107	33,050	17,471	20,642	6,234	6,200	52,812	59,892	.....	7,080

Figure 26. Illustrative Statistical Record.

The members of the institute operate 88 warehouses in 37 leading cities, and the above is one example of how buying hazards have been removed and guess-work eliminated. Likewise, from a sales standpoint, these members can examine the composite reports and ascertain if they are getting their share of tonnage sold according to the 12 major classifications. These statistics also point the way to new and wider markets for reinforcing steel.

Warehouse Costs.—Most of the members of the institute have adopted a uniform system of cost accounting for the operation of their fabricating departments. Monthly reports are supplied to the institute showing the direct labor cost of unloading, cutting, bending and loading the steel, together with the warehouse overhead. The institute in its composite reports shows the average cost per ton for these operations dividing the warehouses into districts as shown in Figure 27.

Upon receiving the average costs for these operations each member can analyze his own costs, and if they are out of line, he can take such steps as are necessary to remedy the situation.

When it is realized that the average producer or distributor has little knowledge of the actual cost of doing business, great credit is reflected upon the reinforcing steel industry and others by reason of their adoption of a uniform system of cost accounting, as a basis for comparative analysis.

Uniform Sales Contract.—As further evidence of the value of collective action and co-operative research, this institute, after months of careful study, has adopted a uniform sales contract. This contract represents the composite experience of the members and lessens the sales resistance previously encountered due to the variance of contract forms. It is a forward step worthy of recognition, and it might be well emulated by other industries and trade associations in the furtherance of progress through comparative analysis.[3]

[3] M. A. Beeman, Sec'y, Concrete Reinforcing Steel Institute Report.

CONCRETE REINFORCING STEEL INSTITUTE CHICAGO
WAREHOUSE COSTS (PER TON) JULY TO DECEMBER 1925
Note: The Costs Shown Below Are the Average of Costs Taken From Six Monthly Reports

	Pittsburgh District Tons per Month				Chicago District Tons per Month				Birmingham District Tons per Month	
	1 to 100	100 to 500	500 to 1000	1000 and Over	1 to 100	100 to 500	500 to 1000	1000 and Over	1 to 100	500 to 1000
DIRECT LABOR—BARS										
1. Unloading	$0.41	$ 0.23	$ 0.21	$ 0.07	$0.32	$ 0.24	$ 0.15	$0.08	$0.23	$ 0.19
2. Cutting	1.00	1.34	1.21	.84	.79	1.03	.97	.82	.84	.79
5. Loading	.28	.16	.22	.15	.29	.35	.18	.12	.35	.38
Total Direct Labor	1.69	1.73	1.64	1.06	1.40	1.62	1.30	1.02	1.42	1.36
OVERHEAD										
18. Total Overhead	5.72	2.09	1.83	2.04	4.77	1.77	1.46	1.08	4.88	1.53
TOTAL COST	$7.41	$ 3.82	$ 3.47	$ 3.10	$6.17	$ 3.39	$ 2.76	$2.10	$6.30	$ 2.89
DIRECT LABOR—BARS										
3. Regular Bending		2.75	2.08	2.06		1.83	2.36	1.85		2.87
OVERHEAD										
18. Total Overhead		3.29	2.56	4.02		2.26	2.13	2.20		2.85
TOTAL COST		$ 6.04	$ 4.64	$ 6.08		$ 4.09	$ 4.49	$4.05		$ 5.72
DIRECT LABOR—BARS										
4. Stirrup and Tie Bending		7.49	6.55	4.98		6.18	5.29	3.78		5.41
OVERHEAD										
18. Total Overhead		9.64	7.84	9.38		7.43	4.86	4.38		6.55
TOTAL COST		$17.13	$14.39	$14.36		$13.61	$10.15	$8.16		$11.96

Figure 27. Illustrative Statistical Record

CHAPTER XIII

DETERMINING THE BORROWING LIMIT ON UNSECURED LOANS

Banker's Conservative Attitude.—Of all the topics for discussion between the borrower and the banker none is more delicate—more full of complexity—than the borrowing limit. An account will often be opened in a bank with no credit favors asked, and the relationship established will be mutually satisfactory. Affairs will progress smoothly until the time comes for a loan. Then the commercial depositor will approach the loaning officer's desk and ask the inevitable question: "What is my borrowing limit?"

It is a matter of policy with most banks to be rather hesitant to establish, unsolicited, a line of credit for a customer or prospect. Indeed, it is the general custom among conservative bankers to allow the prospective borrower to take the initiative in most instances and to ask for the line of accommodation he desires in keeping with his requirements and resources, and then to determine whether or not they care to extend credit for the amount asked.

As a matter of fact this is the logical procedure. The banking business is attended with considerable risk, owing to the number of commercial failures which, for one reason or another, occur each year. And it is but natural, in view of the risk involved, for the banker to consider not so much what the depositor is entitled to, as what risk the bank is prepared to assume. If the banker took the initiative in many instances, he would soon find his files filled with unworthy credit applications, his deposits dissipated, as a result of the ruffled feelings

of turned down credit-seekers; and the time of his discount committee largely taken up with the consideration of unnecessary and too often unprofitable credit problems.

Considering for the moment the banker's position, it is enlightening to observe what statistics indicate credit risks amount to according to the law of averages, and as indicated by the table in Figure 28, prepared from the record of business failures compiled by Bradstreet's as of January 10, 1925. A study of the failures, including the assets, liabilities, and the number engaged in business in the United States since 1881, is quite illuminating. It shows that .89% failed in 1924, as compared with but .29% in 1919; the latter being the most favorable year, in point of failures, shown in Bradstreet's records. Failures are steadily increasing as the hazards of business become greater through competitive and other conditions, which in some instances cannot be helped, and also because of the increased number of enterprises and the many factors affecting them. The percentage, it will be noted, increased during periods of panic, as in 1893, 1907-8, and in 1922 during the deflation.

In considering the foregoing, it is apparent that the risk taken by the banker is a serious one and that it becomes naturally greater during periods of financial stress. And since the banker is only human, it is not unreasonable to conclude that like every other business man, he appreciates that the ideal policy is to assume as little risk as possible and at the same time make the greatest profit consistent with good business. Yet too much caution, on the one hand, means stilted progress for the institution. Too much optimism, on the other, leads to thoughtless over-expansion, exceeding the limits of sound borrowing, and the ruin of potentially productive enterprises.

When the Borrower Asks for a Line of Credit.—Let it be assumed, now, that a customer has opened a substantial account

Year	No. failures	Per cent increase or decrease	Actual assets, millions	Total liabilities, millions	Per cent assets to liabilities	Number in business	Per cent failing
1924	19,608	+2.8	$420.4	$688.7	61.0	2,195,626	.89
1923	19,159	−14.5	369.1	631.2	58.4	2,136,921	.89
1922	22,415	+11.9	365.6	649.8	56.2	2,074,617	1.08
1921	20,014	+136.4	446.6	755.7	59.0	2,049,323	.97
1920	8,463	+53.4	274.1	426.3	64.3	1,958,042	.43
1919	5,515	−40.8	55.3	115.5	47.9	1,843,066	.29
1918	9,331	−28.3	69.3	137.9	50.9	1,824,104	.51
1917	13,029	−21.0	84.8	166.6	50.9	1,828,464	.71
1916	16,496	−13.3	86.1	175.2	49.1	1,790,776	.92
1915	19,035	+13.4	160.8	284.1	56.5	1,770,914	1.07
1914	16,769	+15.2	197.2	357.1	55.2	1,749,101	.95
1913	14,551	+5.3	159.0	292.3	54.3	1,718,345	.84
1912	13,812	+9.2	98.5	198.9	49.5	1,673,452	.82
1911	12,646	+9.2	102.0	188.1	54.2	1,637,650	.77
1910	11,573	−2.3	94.2	188.7	49.8	1,592,509	.72
1909	11,845	−15.6	69.3	140.7	49.2	1,543,444	.76
1908	14,044	+36.8	168.4	295.9	56.9	1,487,813	.94
1907	10,265	+9.3	287.9	383.7	75.0	1,447,680	.70
1906	9,385	−5.9	63.1	127.2	50.0	1,401,085	.66
1905	9,967	−4.3	65.0	121.8	53.3	1,352,947	.73
1904	10,417	+6.5	75.7	143.6	52.7	1,307,746	.79
1903	9,775	−1.9	84.1	154.3	54.5	1,272,909	.76
1902	9,973	−6.3	50.4	105.5	47.7	1,238,973	.80
1901	10,648	+7.4	61.1	130.1	46.9	1,201,862	.88
1900	9,912	+2.8	60.1	127.2	47.2	1,161,639	.85
1899	9,612	−16.9	60.1	119.8	50.1	1,125,873	.85
1898	11,615	−11.2	73.1	141.6	51.6	1,093,373	1.06
1897	13,083	−13.3	86.5	158.7	54.5	1,086,056	1.20
1896	15,094	+16.4	147.8	246.9	59.9	1,079,070	1.40
1895	12,958	+1.8	87.6	158.7	55.2	1,053,633	1.23
1894	12,724	−17.9	83.2	151.5	54.9	1,017,974	1.21
1893	15,508	+51.0	231.5	382.1	60.6	1,059,014	1.46
1892	10,270	−17.1	54.7	108.6	50.3	1,035,564	.99
1891	12,394	+16.1	102.9	193.1	53.3	1,018,021	1.21
1890	10,673	−9.0	92.7	175.0	52.9	989,420	1.07
1889	11,719	+10.7	70.5	140.7	50.0	978,000	1.20
1888	10,587	+9.7	61.9	120.2	52.0	955,000	1.10
1887	9,740	−7.8	64.6	130.6	50.0	933,000	1.04
1886	10,568	−4.9	55.8	113.6	49.0	920,000	1.15
1885	11,116	−4.3	55.2	119.1	46.0	890,000	1.25
1884	11,620	+13.0	134.6	248.7	54.0	875,000	1.32
1883	10,299	+34.0	90.8	175.9	52.0	855,000	1.20
1882	7,635	+28.0	47.4	93.2	51.0	820,000	.93
1881	5,929	.....	35.9	76.0	47.0	780,000	.76

Figure 28. Failures, Assets, Liabilities and Number in Business in the United States Yearly Since 1881

and that for some time relationships have remained undisturbed. Then one day in he comes.

"How much of a loan, at the maximum, will the bank be willing to make me?" he asks. "How much do you need?" the wise loaning officer may reply. The foregoing is an introductory proposal for an unsecured loan. It happens every day in thousands of banks throughout the country. Often the question is put and an answer expected without giving the banker a chance to investigate or consider, to say nothing of securing the necessary checkings and a financial statement.

Under what circumstances do customers and prospects ask for their borrowing limit? Why do they want to know what their limit is? What are some of the considerations which influence the banker in arriving at what he believes to be the right credit limit? These are a few of the significant questions which arise in the mind of the student of finance and which often perplex the banker, involving as they do some of the finest points in loaning finance.

Circumstances Under Which Credit Limits are Asked.— It is a common experience in most active commercial banks for an officer to be approached on the question of the borrowing limit several times a day. Obviously, after handling thousands of applicants, a seasoned banker becomes familiar with the different types of borrowers and learns how to handle the various cases which arise. Space would not permit of a discussion of all the complex situations which come up over the question of the borrowing limit, but by way of illustration, a few cases will be cited of the sort that occur during a business day:

First of all, there is the customer who carries good balances, who has never borrowed from his bank and hopes he may never have to, but because he foresees the possibility, wants to know his credit standing with his banker. "How

much can I have if I need it?" he will ask. "How much do you think you will ever need?" the banker often will reply.

In such cases, if everything appears satisfactory and the depositor is insistent and wants a definite line of credit passed, and is not merely asking for information, the banker will ask for checkings and such data as he desires and prepare to take the matter up before the bank's discount committee.

Oftentimes a depositor will only be asking for information. He does not actually care for a line of credit and has only approached the banker to "feel him out." Under such circumstances the loan official, after sizing up the situation, makes such assurances as he feels are warranted by conditions; and if the customer's statement is tendered and it is not a good one, the banker may point out ways of improving it and thus ultimately free the prospective borrower from a possible credit rejection by the bank because of defects in his financial structure, or in methods of conducting his business.

Another common applicant is the business executive who comes over to "shop" from another bank. "How much am I entitled to?" he asks. More than likely the "shopper" has, for some reason or other, failed to get what he needed elsewhere or what he thought he needed, and wants to get some gratuitous information.

Banks often find that such prospects are unreasonable and are difficult to co-operate with; sometimes they are merely ignorant of financial matters. Space will not permit the discussion further of this classification more than to say that a well-versed loaning officer is not inclined to commit himself, and rather wishes to know first whether the prospect intends to open an account. Such cases are often disposed of by asking the borrower to open an account and allow the banker to study the way it is handled, the balances, and other details. Then, after the banker has familiarized himself with the situation, he is in a position to judge what the prospect is entitled to, and not before. Often, too, the banker, upon learning of the de-

positor's relations with the other banker, comes to the conclusion that it would be doing an act of kindness to advise the individual to remain with his original bank.

A very interesting analysis for the banker arises when a newly formed corporation approaches him for a line of credit. Often thrusting before the banker a mere statement of assets and liabilities, having no past operating history, offering little in the way of checkings outside the records of the officials of the company, such applicants try the banker's patience and skill to the utmost. If relations are to continue, the banker is expected to give some opinion of what the company will be entitled to in the way of a credit limit.

"How will I know how the statement and conditions will be after 6 months' operation?" the banker may ask. Indeed, more than one banker has lost a "valuable" deposit balance, all because he was honest enough with the customer or prospect not to attempt to play the part of a soothsayer.

In such cases the banker has a right to study the progress of the company before he is expected to commit himself on a line of credit. Out of every 100 new companies wanting accommodations, there will be some which are deserving of the banker's confidence. The skill exercised by the banker in choosing the right ones to support will reflect in a large measure the progress of that banker and his institution.

When the financial executive for a reorganized corporation, which has carried balances in substantial amounts, comes in for credit favors, the banker finds the situation regarding the borrowing limit still more intricate. It is a matter of record that reorganized business enterprises often prove only prolonged failures. The delicate readjustments necessary to put a reorganized company on its feet again often prove impossible of realization, with the result that as a banking risk they are looked upon with caution bordering upon suspicion. When the question of the borrowing limit comes up, the loaning officer naturally takes into consideration the previous his-

tory of the old corporation, especially if the officers and the personnel are the same, makes a financial comparison of the new set-up with the old, and draws his conclusions as to how much the risk is entitled to. Just what limits he will place will depend upon a number of things which will be discussed in detail later.

One of the most practical cases which occur daily in most commercial banks, is that of the borrower who wishes to switch banks, transferring his loans along with his accounts. When the application is for unsecured borrowing, the banker particularly wishes to know why the change is desired, what the borrower received in accommodations at the other bank, what his borrowing limit was, and what his financial standing was with the other institution.

In some instances a borrower changes because he feels that he was held down by too conservative loaning policies; and again, the depositor may have been so liberally treated at his former banking connection that the new bank does not feel able to do as well. But there is an old saying that a customer entitled to it can get accommodations in any well-managed bank, and it is a matter of importance to emphasize here the fact that bankers usually work so closely in credit dealings that generally there is little competitive bidding over the question of establishing a judicious borrowing limit. Competition arises rather over matters of service. Thus experience reveals a close harmony among bankers as to what constitutes the borrowing limit, although it may be more or less a matter for individual opinion, tempered by a careful sifting of the facts, and of the personal factors which carry much weight in particular cases, as has already been pointed out in previous sections.

Expansion and future plans influence the limitations of the borrower. Viewed from the standpoint of scientific analysis, the issue is not when or how much a firm should expand with banking support. Rather the question the credit man asks is—

granting the firm is expanding logically—"Is such expansion and banking support of such expansion, warranted by past financial results achieved, taking into consideration the probable returns in the future?" The difficulty in answering these questions is apparent when one stops to consider that expansion is a long-time financial matter and its potential profitableness is latent in future business conditions which are an unknown quantity. It is for this reason that the loaning officer regards expansion and expansion programs from the standpoint of how such development may affect a firm's immediate and short-term credit position.

When setting the limits for a concern, a bank needs to know particularly whether or not there will be any resultant strain on its working capital position or on its earning power by the increased charges incurred through a course of expansion financed by unsecured credit. Thus when marking out the limits the banker, by scientific analysis, tries to determine whether the expansion is commensurate with the rate of growth in volume of business in the past and in the present. Will the aid of banking support produce a profitable undertaking in the near future so that the financial burden will not be felt unduly by present resources upon which the efficiency of the present unit depends? That is the question.

Of course, when revolving in his mind the foregoing considerations, the banker does not overlook the results reflected in the ratios shown in the statement. After the loan has been made, will the borrowers' statement show a satisfactory ratio of current assets to current liabilities, whether that be two to one, three to one, or some other ratio which experience reveals is commensurate for a particular type of business.

As illustrating how the ratio affects the banker's attitude toward the borrowing limit, the comparative statement of a steel mill manufacturing sheet metal is recalled. It was perceived that the ratio of current assets to current liabilities dropped from 6.87 to 1 in 1920 to 1.90 to 1 in 1922. The sur-

plus quick assets showed an abnormal decrease, while the current liabilities were more than doubled. Because it considered these factors unfavorable, a bank's discount committee refused to extend further the limit of its accommodations on the showing made by this concern.

How Lack of Financial Control Demands a Borrowing Limit.—A big factor around which the banker's thought centers when determining the limits of unsecured credit, is the effect the control of finances has on a company's position. In every type of business there is a period of production and a storing up of goods preceding the selling period and the subsequent collection of accounts. Also, there will always be a considerable gap between the accepted order and the date of collection for delivered goods, and it is for this interval that the manufacturer needs financing and wishes to know how much assistance he may expect from his bank. His own funds may be partly sunk in plant and equipment and partly in inventories. The residue may not be sufficient for his entire manufacturing needs. He, therefore, wishes to know to what extent he may depend upon the co-operation of his commercial bank to tide him over. It is true that many concerns are able to get such liberal terms in the purchase of supplies that this phase of financing and the question of the borrowing limit do not affect them. Yet it would be safe to say that a large majority of concerns are vitally taken up with the matter of raising funds to tide them over periods of great financial outlay, and must know their borrowing limit.

But in determining what limits to establish for a particular concern the banker studies the financial structure, and considers the management's control over the company's finances. For without adequate control failure results.

As has already been disclosed, the financing usually takes the form of short-time obligations. To cite an example, as the business of a concern expands and as the volume of sales in-

creases, so the gap between order and payment date accumulates, bringing with it a greater need for increased banking accommodations, and these are usually granted regularly, for the increase of business when properly balanced, is a warrant, under capable management, of successful enterprise. New loans are made and old ones renewed and extended, and the judicious limits of borrowing are exceeded until the conviction insidiously grows on the part of the manufacturer that these short-term accommodations are a fixed contribution to the capital of his business and he acts and works upon this assumption. Inevitably the day comes when the bank finds itself pressed for funds and in turn calls on the manufacturer for payment, and since such a demand usually comes at a time of business depression, the manufacturer finds himself unable to liquidate. Then very likely a reorganization ensues, resulting at best in the short-term funds becoming, upon onerous terms, a part of the funded or long-term obligations.

Commercial Bank Not Borrower's Partner.—When a commercial loaning policy of too much renewed paper is followed, where loans are continuous, it is but natural that the borrower should be tempted to look upon the banker as his partner in the enterprise, rather than as a mere lending associate. James B. Forgan, former president of the First National Bank of Chicago, in his "Recollections of a Busy Life," suggests an attitude toward such a situation which is as equitable for the borrower as for the banker. "A line of credit should be the maximum amount of a customer's paper which, under ordinary conditions and during the satisfactoriness of his account, a bank will take from a borrower without agreeing to grant renewals." "This will not prevent the bank from taking existing conditions into account and doing all he can for his customer, but it will release him from a contract which it may be impossible for him to fulfill, and no conservative banker will enter such a contract."

Banks cannot be placed in a position as partners. They must insist upon immediate as well as ultimate liquidity of every loan. Thus every enterprise should not only have enough money invested in the business to pay for the fixed assets, but should have enough ready working capital so that the minimum funds needed during, say, a two or three months' season at the low of operations, should be provided for by capital investment.

Bank's Position Relative to the Borrower.—Every borrower, if he would stop to consider the small interest return realized by the banks on commercial loans running along from month to month on market interest rates, will readily appreciate that a bank cannot afford to take a capital risk. In other words, the nature of the banking business precludes the acceptance of an indefinite risk involving the possibility of loss out of all proportion to the financial gain.

Shifting the Borrowing Burden from One Bank to Another.—Some companies find it extremely difficult to liquidate their bank indebtedness at any time during the fiscal year, and to keep the goodwill of their banks shift their borrowings from one bank to another in order to make a periodic clean-up of loans. While this has some advantages, still, in the event of financial difficulty or disappointing earnings, experience shows that the banker who is carrying the responsibility often has a frozen loan on his hands.

The only solution for a situation of this kind lies in the addition of more capital. When a business has grown to such a point that its lowest activity demands more funds than its net worth, it is essential to put in more capital. It is true that a conservation of earnings ploughed back into the business often will answer the need. But the main thing is to provide sufficient funds so that the net worth will be sufficiently increased to care for and support the business at the lowest ebb of its activity.

Periodic Liquidation Essential.—While in rare instances a new and rapidly growing enterprise may find it unusually difficult to pay off all its unsecured bank indebtedness annually, because, as the business expands, working capital is needed more urgently than it can be furnished by the business itself through reinvested earnings, still, there is a well-established policy among all well-run banks to insist upon the annual "clean-up" of loans irrespective of the nature or age of the business.

Because of the importance of periodic paying up of loans in financing a business, the Department of Manufacture of the Chamber of Commerce of the United States not long since sent out a query to twenty prominent bankers to get their reaction to the practice of banks requiring the periodic clean-up of loans. This is how the question was put, and this is the reply:

First of all, "Is it feasible for manufacturers so to plan their financial requirements that, while borrowing considerable funds at the peak of the manufacturing season, they will, once a year, for a period of thirty or sixty days, go out of debt?" And going out of debt was defined as having cash in the bank comfortably in excess of the outstanding bank loans. The question was prompted by the conviction of a manufacturer of farm implements that "If all executives would plan the conduct of their business in advance of the coming year with full regard for the relationship between their available capital and contemplated production and sales programs, with the object in view of being able to pay all current borrowed money during or at the end of the year, we would make the business of this industry highly desirable from a banking standpoint."

This research showed that the opinion of the bankers was emphatic that the liquidation of current obligations was a practicable and desirable goal, and one to which they held their customers in seasonable lines, where the production proceeds to a peak, followed by settlement when the inventory and accounts receivable are lowest. One banker wrote:

"Perhaps the largest single cause of commercial failures is due to lack of capital, which is another way of expressing too much expansion for the capital employed. It has been the conception of this bank's organization and its consistent policy to impress on the customers the necessity of seasonal liquidation of debts. You, of course, appreciate that seasonal liquidation in the case of one customer may mean a monthly clean-up, and with another customer a quarterly, semi-annual or annual. We have endeavored to require liquidation from our customers as often and at such seasons as the character of their business would best correspond with the annual clean-up marking the end of the longest extension of credit."

So much for seasonal lines. But "there are other industries," writes Harry A. Wheeler, president of the Union Trust Company of Chicago, "where such a course is physically impossible unless the capitalization of the company is larger than should conservatively be carried. I speak of commodities and lines of business where the trade is steady through the year, or with one or two peak points only a little above the normal average. The automobile business is one where a seasonal balance can be struck at one period of the year. In lines of wearing apparel, where definite seasonal requirements are observed, the same thing is true. The packers cannot have a complete liquidation, nor can the distributors of any food product or of other commodities where the consumption is continuous." [1]

To sum up, it is apparent that the commercial bank's function is to supply funds sufficient to enable the manufacturer to pass the strain at the peak of his season. The well-managed and well-financed business limits its borrowings in this manner and liquidates its loans annually, with the realization that the conservative banker must guard against continuous borrowings from all sources, and looks to the company to provide for its

[1] Department of Manufacture, Chamber of Commerce of the U. S. A., pamphlet "Budgeting for Business Control," p. 17.

own minimum needs in the dull season in the cycle of yearly business.

Factors Which Tend to Decrease the Loaning Limit.— For every business there are circumstances which are ideal for its successful operation; for every business, too, there are certain achievements which may or may not be possible of realization. It is true, too, that every firm or corporation has its limitations, which it is necessary to overcome before the highest progress is possible. For a firm or corporation these limitations are many—too many, in fact, to elaborate upon here. But to point out how external and self-imposed limitations affect the borrowing limit, it is opportune to list here a few of the many common failings which in a measure create inhibitions in the banker's mind, hedge in his confidence, and tend to cause him to withhold credit. These recognized shortcomings, which cause the banker to limit his credit, are as follows:

1. At times balances run below regular requirements and there is a tendency to overdraw the account frequently. This may be due to sharp practice, incompetence, lack of capital, slow collections, or poor credit policy. It indicates a lack of good business methods and is injurious to the borrower.

2. Occasionally there are notes and trade acceptances given in payment of bills, and there is frequent inquiry from outside sources regarding the credit standing of the concern, indicating that bills formerly paid by check are now being paid by notes. This implies a weak condition in the concern and may point to incompetence, lack of capital or its deliberate misuse. Commitments for merchandise or services or accommodations in such circumstances should not be entered into without a definite plan of payment.

3. Trade records changing from "discount and prompt" to "slow pay" may also cause the bank to curtail its loans. This is similar to the first two conditions suggested, in that it shows

lack of capital, possible over-stocking, and a weak collection policy.

4. When there arise suits or attachments, there is an indication of poor policy as to payment of bills, or other weaknesses such as inferior goods. They are often due to many of the same causes as above.

5. Assignments of lease or chattel mortgage are sometimes important and suspicion of fraudulent disposition of property; and even when done in good faith, are often evidence of poor management as to costs, financing, and method of payment.

6. Sometimes it is found that the personal habits of officers are not in keeping with the position occupied or the responsibility involved. For example, rumors of extravagance out of line with good judgment, newspaper clippings, and other like factors may influence the loan official in determining the borrowing limit. Possible neglect of business is sometimes indicated. It means, in some cases, ill-advised, if not illegal, diversion of funds to the personal accounts of officers, and an insufficient amount of money put back into the business.

7. Again, incorporating under the laws of a different state may prove a disadvantage from a credit angle. Except in a few special cases, where a change in state laws might make this advisable, it can and often is taken as evidence of a desire to escape legal responsibility or to lower the standards. Both are undesirable.

8. Straying away from good business practice evidenced either by price-cutting or unfair competition may also influence the banker unfavorably. Proof is often rather difficult, and evidence is usually indirect, but when found by the banker it is considered a good warning signal. For the man who is unscrupulous with his associates will not be fair with creditors if he sees a chance to protect himself through unethical methods.

9. Frequently the purchase of real estate for speculative purposes, especially in cases where the land is not required by the business, is considered as unfavorable. In such cases where

the real estate is actually purchased for the use of the business, the cost and location are important. This tendency to dabble in real estate speculation, diverting to such a purpose funds needed for running the concern, may be the only weak point in the borrower's armor, but its existence may give warning to the bank to give the affairs of the company the closest scrutiny. Occasional good fortune may bring things through safely, but in the majority of cases it presages a shortage of working capital, increased need of loans, slow payment, and thereby tends to limit the banker's confidence.

10. Refusal to submit information to mercantile agencies is sometimes regarded as an unfavorable sign. It is claimed that a sound concern, in a strong position, has no desire to conceal its condition. It is sometimes taken as an indication of weakness or as a warning of impending fraud of some type, such as the change of control or policy without knowledge of trade or creditors. But ordinarily a banker would not take a refusal as necessarily indicating any of these things.

11. Continuous borrowing also tends to limit the borrower. This point has been already covered. The information is easy to obtain, as it is available in the bank's own records or through the co-operation of other banks also carrying the account. It may mean nothing more than short-sightedness, and it may indicate trouble from personal extravagance, too high fixed expenses, too weak sales, or a change in economic conditions. In any case, it is a sign which the banker observes when establishing the credit limit.

12. Deeding property to some member of the family or filing homestead is also important. This is usually done in anticipation of disaster, and when discovered should indicate that the officers involved fear the ability of the concern to survive, and that they are trying to evade personal liability for the losses of the company.

13. Borrowed money used for fixed assets instead of using profits or obtaining funds for this purpose through the sale of

stock is regarded at times so seriously as to cause a bank to call its loans. This has been given some emphasis already and as stated previously, plays a significant part in judging a risk. It is one of the most important considerations in limiting a prospective borrower's chances for accommodations.

14. Discounting contracts and receivables to a finance company, at the same time obtaining credit from a bank unsecured, often limits the borrower; sometimes prevents him from getting any accommodations whatever. This indicates lack of working capital and frequently is done to conceal the true condition of the company. It is important for the banker to consider this angle when establishing the borrower's prospects for a loan.

15. A small business carrying more than one bank account. If one bank is unable to meet the modest requirements of a small concern, there must be some reason why this is true. Again, if a borrower has a $10,000 line of credit and splits his account, ordinarily the first bank will cut its own line to $5,000, and the second limit its credit in like amount.

16. Economic and climatic conditions and location may limit the borrower. Strictly speaking, these limitations are not often within the scope of the individual or concern's power to control, but may be in fact external. Yet they still prove an important factor in relation to borrowing limits when considered in the light of all the circumstances. Indeed, the author in making an investigation of 50 concerns which were rejected by the discount committees of banks throughout the country found that 7 out of 50 rejections were because of unfavorable location and other related causes.

17. Not infrequently the character and amount of notes and accounts receivable play an important part. Notes are often taken, as has been brought out in previous sections, for past due accounts and in many cases are of a doubtful nature. In general this item should not be more than the percentage of receivables to sales indicating proper collection terms for a particular business. Where receivables appear large, it might be

due to excessive credit or lack of attention to collections. There should be a reserve for doubtful accounts. If the receivables are discounted, the contingent liability should appear on the statement. If there is any question about the amount being too large, a detailed list of the notes should be obtained.

18. The merchandise inventory may be a significant factor in determining the borrowing limit. This account should show proper turnover for the particular line of business. If the inventory is too heavy, it might indicate a desire to speculate, falling off in sales, or poor judgment in buying. Through the handling of this account a given concern can show a profit or loss, a liquid or weak financial condition, depending upon whether or not the inventory was properly taken and valued. The concern which is not making satisfactory progress will generally resort to padding the inventory in order to show that it is operating profitably.

As indicating the effect that the inventory has on the borrowing limit, Figure 29 presents the statement of a coach building company rejected for further accommodations because the inventory was out of line with the cash in bank, notes and accounts receivable. Two-thirds of the quick assets were tied up in the inventory. It was thought possible that in the event of financial depression this inventory might prove topheavy and become a financial embarrassment. Thus it acted as a limit on the corporation's borrowing capacity.

19. The question of depreciation is also considered. This item is an important item in influencing the banker in deciding what he shall do in establishing his credit limit, and is related to the inventory. As already indicated in a previous chapter, insufficient depreciation swells book profits. Repairs and renewals are sometimes charged to asset accounts instead of to operating accounts. This might mean the difference between profit and loss. Depreciation varies with the type of business, but should be adequate to cover replacement by the time the article or machine has worn out or has become obsolete. Good

CORPORATION — COACH BUILDING COMPANY

Comparison of Statements

CONDENSED STATEMENT:

Date,	3/31/23	12/31/24	12/31/25	12/31/26
Quick Assets	1,653,573	667,123	711,821	884,365
Current Liabilities	1,355,376	521,399	226,126	326,775
Ratio Q. A. to Liabilities	1.22 to 1	1.27 to 1	3.15 to 1	2.70 to 1
Surplus Quick Assets	298,197	145,724	485,695	557,590
Other Assets	468,737	625,150	628,880	839,014
Total Assets Less Current Liabilities	766,934	770,874	1,114,575	1,396,604
Less Mortgages and Reserves			45,000	
Net Worth	766,934	770,874	1,069,575	
Capital—Preferred				
Capital—Common	400,000	400,000	350,000	350,000
Surplus	366,934	370,874	719,575	1,046,604
	766,934	770,874	1,069,575	1,396,604
Total Sales				3,763,101
Net Profit or Loss				
Dividends Paid				
Chg'd off, depreciation and bad debts				
Carried to Surplus				
QUICK ASSETS:				
Cash on hand and in bank	191,785	34,941	132,181	153,058
Notes Receivable	304	350	350	18,834
Trade or Bank Acceptances				
Accounts Receivable	464,483	171,440	30,414	77,093
Mdse. finished	996,999	421,801	515,545	586,598
Mdse. unfinished				
Raw Material				
Mutual Fire Ins. Deposit			11,868	19,352
Cash Value Ins.		38,590	15,826	18,435
Advanced Expenses			5,636	10,995
OTHER ASSETS:				
Real Est. Plant, etc	195,394	246,302	628,630	808,762
Machinery and Tools	162,347	170,653		
Goodwill, Patents, Patterns, etc				
Licenses		1		
Unlisted Stocks and Bonds	70,420	33,242	250	30,250
Deferred Charges	23,951	18,729		
Furniture and Fixtures	8,970	21,884		
Auto and Trucks	7,654	8,098		
Other Investments		126,238		
CURRENT LIABILITIES:				
Notes Payable	960,000	308,068		175,000
Trade or Bank Acceptances				
Accounts Payable	203,803	191,641	189,390	68,893
Wages, Salaries			30,685	
Accrued	67,656	21,689	6,049	25,882
Reserve for Taxes	123,917			57,000
OTHER LIABILITIES:				
Mortgages				
Reserve Accounts			45,000	

Figure 29. A Statement of a Coach Building Company which at the Time Showed an Excessive Inventory

accounting principles, as heretofore suggested, will indicate proper depreciation for each type of asset. Insufficient depreciation in a new concern might be due to ignorance, in an older concern it indicates a desire to take out in salaries or dividends more than is safe. In any event it is a danger signal and should be closely observed when the borrowing limit is arranged.

20. Failure to submit promptly a statement when requested also creates an unfavorable basis for establishing healthy borrowing limits. When revising or checking its files or lines of credit the bank may ask for a new statement. When there is reluctance shown, and a tendency to withhold operating details, it is time for investigation. Such an attitude often indicates a desire to conceal the true condition of affairs, and means that the statement when it does appear should be even more carefully analyzed than usual, and the borrowing limit well looked into.

21. A liberal dividend policy and withdrawal of earnings instead of providing for future contingencies also needs some consideration. In this case the personnel of the stockholders should be investigated. If control is too concentrated, personal desires may be made to take precedence over the best interests of the company. The conclusions arrived at after an investigation has been made will help the banker in establishing his borrowing limits.

22. Falling off in current position. To emphasize the above mentioned point, and the importance of the current position in the banker's consideration, it may be timely here to illustrate with a statement. The comparative statement of a flour milling company on page 431 shows a steadily declining ratio of current assets to current liabilities, which is an unhealthy sign. Again, referring to the matter of dividend payments above, it will be noted that during the years 1924 and 1925 considerable money was due the stockholders; then in 1926 the statement does not show any due. Naturally, the banker in establishing the bor-

rowing limit wants to know the circumstances in point to understand what the disappearance of the item signified, and whether its effect on the policy of the company was favorable or unfavorable. It is of interest to note here in passing that the discount committee of an eastern bank did not care to accept the notes of this concern after studying the statement and checkings, believing that it did not at that time make a satisfactory showing in the light of all the facts.

23. Insufficient cash to take care of current requirements. Here, too, an example is shown which indicates inadequate bank balances. The statement of the provision company shown on page 461 was thought unsatisfactory because of too small bank balances. It will be noted that while the company has a net worth of over $6,000,000, its cash balance is shown at only $13,943. Also, the ratio of current assets to liabilities is less than two for one, which is not as it should be under ordinary conditions for this type of business. All these factors the banker takes into consideration when setting his limits for unsecured banking credit.

24. Falling off in sales or profits is obviously a reason for limiting credit and will not be elaborated upon.

25. Under-capitalization often influences the banker unfavorably. This condition will show a heavy debt-to-worth position, and too large a volume of business for the capital employed. It will not be attempted here to discuss the ratio of debt to net worth. Depending upon a number of things, the ratio varies, and taking all the necessary factors into consideration, the banker, in establishing his borrowing limit, decides whether the debt is excessive.

By way of illustration there is shown in Figure 30 the statement of a newsprint manufacturing company rejected by a bank's discount committee for further credit. It shows a steady decline over a four-year period in net worth, quite a substantial amount in floating debt and total debt; and a not too favorable ratio of current assets to current liabilities, being less than two

CORPORATION NEWSPRINT MANUFACTURING COMPANY

Comparison of Statements

CONDENSED STATEMENT:

Date,	12/31/23	12/31/24	12/31/25	12/31/26
Quick Assets	32,182,900	37,147,795	35,258,103	29,773,510
Current Liabilities	11,858,573	11,058,726	18,962,439	15,081,928
Ratio Q. A. to Liabilities	2.71 to 1	3.36 to 1	1.86 to 1	1.97 to 1
Surplus Quick Assets	20,324,327	26,089,069	16,295,664	14,691,582
Other Assets	55,602,018	61,243,156	66,611,887	71,475,666
Total Assets Less Current Liabilities	75,926,345	87,332,225	82,907,551	86,167,248
Less Mortgages and Reserves	9,089,218	9,838,594	13,973,062	26,531,222
Net Worth	66,837,127	77,493,631	68,934,489	59,636,026
Capital—Preferred	24,771,210	24,825,308	24,839,288	24,910,204
Capital—Common	19,803,920	19,850,264	19,905,104	19,923,032
Surplus	22,262,167	32,818,069	23,875,179	14,802,790
	66,837,127	77,493,631	68,934,489	59,636,026
Total Sales		67,000,000	27,416,000	34,987,000
Net Profit or Loss		12,055,000	1,166,000	4,725,000
Dividends Paid				
Chg'd off, depreciation and bad debts				
Carried to Surplus				
QUICK ASSETS:				
Cash on hand and in bank	2,641,833	2,056,933	1,237,398	1,687,327
Notes Receivable	533,465	914,168	156,244	501,044
Trade or Bank Acceptances				
Accounts Receivable	5,709,274	8,865,278	3,082,307	6,722,834
Mdse. finished	23,298,328	25,311,416	30,782,154	20,862,304
Mdse. unfinished				
Raw Material				
Listed Stocks and Bonds				
OTHER ASSETS:				
Real Est. Plant, etc.	43,326,136	47,729,477	53,643,665	57,199,682
Woodlands	7,589,739	9,334,795	8,587,773	7,828,633
Goodwill, Patents, Patterns, etc.				
Due from Officers, etc.				
Unlisted Stocks and Bonds	4,087,717	3,646,444	3,509,429	3,600,906
Deferred Charges	466,716	479,438	819,881	2,794,958
	131,710	53,002	51,140	51,485
CURRENT LIABILITIES:				
Notes Payable	8,500,000	1,595,918	16,039,577	12,623,132
Trade or Bank Acceptances				
Accounts Payable	1,526,259	1,553,046	2,446,711	2,083,754
Res. for Det. Div.	547,490	518,014	364,818	
Div. & Int.	376,658	376,458	376,250	375,041
Res. for Taxes	908,166	7,015,280		
OTHER LIABILITIES:				
Mortgages	6,981,500	6,651,500	7,171,000	19,383,500
Reserve Accounts	2,107,718	3,187,094	6,802,062	7,147,722
	3,025,000 July, 1925	Outstanding with commercial paper brokers		

Figure 30. A Statement Showing a Steady Decline in Net Worth over a Four Year Period

for one. It will be further noted that while the net worth shows a decrease, the floating debt shows an increase. The heavy notes payable might also indicate under-capitalization and necessitate the payment by notes instead of cash.

26. Profits not bringing fair returns on the investment are important. The risk involved in business entitles a fair return on the investment. If a concern is unable to employ its funds profitably, it has no real place in the business world.

On page 445 is the statement of a lumber and kraft paper manufacturing company which at the time was not making the progress it should on the amount of capital invested. A discount committee of a banking institution passing upon the borrowing limit expressed their opinion of the risk in their minutes as follows: "We have not been altogether impressed with the progress the company has made since 1922, and for the present, at least, we would be inclined to give preference to other concerns."

Conclusions.—What shall be the borrowing limit? Some of the influential considerations have been pointed out which weigh heavily with the banker in making his decision on what the borrowing limit should be for any individual, firm or corporation. For every concern it should be a worthy ideal to work toward the widening of its borrowing limits and to achieve, ultimately, a position of financial independence, just as should the individual. To-day, there is a tendency on the part of bankers as never before to give financial advice as well as financial assistance. It should be the aim of every thinking commercial borrower to take advantage of this desire to cooperate in helping to build and finance industry; and as the banker and his borrowers go on, hand in hand, it is to be hoped that each will assist the other to outgrow his limitations and thereby widen the horizon of future achievement.

CHAPTER XIV

PROFIT AND LOSS STATEMENTS AND THEIR INTERPRETATION

Up to the present chapter thought has been centered around the balance sheet as the great link in financial credits—that indispensable visualization of static financial history without which no thinking banker is ready to grant accommodations. But important as the balance sheet is in the chain of banking credit, there is yet another link which is regarded as of almost equal importance, the profit and loss statement. Oftentimes referred to as the income statement, presenting to the banker a supplement to the balance sheet, it is invaluable in revealing the changes that occur in the statement during the accounting period. Indeed, the income statement is simply an operating statement of a business as it advances, and often offers dramatic sidelights on what one might otherwise believe from studying the balance sheet was a prosaic credit problem. It is, in fact, the missing link without which no chain of credit circumstances, upon which a loan is to be suspended is complete.

In the present chapter the usual items found in an income statement will be discussed briefly with the aim of depicting some of the elementary principles involved, so that the reader may analyze such a statement when tendered for a commercial loan. It is further proposed to show the importance of the profit and loss statement in connection with the balance sheet, and disclose how the banker and borrower may, by synthesis, piece together the business history of a firm or corporation and thereby form an accurate judgment of its financial condition.

Growing Importance of Income Statements.—With specialized knowledge as applied to commercial bank loans intelli-

gently administered by men trained in the operating and administrative ends of an industry, there is a growing appreciation of the value of income statements, as compared with balance sheets, which are limited to a mere summary of conditions existing at a particular time. Indeed, to the experienced banker, a good or poor risk is not necessarily apparent on the balance sheet. The reason for this is that the average loan is for a period of 60 days, and some loans for 90 days or even longer, and a great many changes of form take place in the interim in the financial status.

It is regrettable that bankers in the past have often not known until the end of the year whether a company to which credit had been extended was losing or making money. The tendency of the lending banker to rely too much on his client not losing his liquid assets before the maturity of a loan, rather than on helping the borrower increase the value of his assets during the period of the loan, has given place to a new realization that if income and expenses are under proper control, a satisfactory balance sheet will inevitably follow.

Thus, with the exigencies of modern business, more loans to enterprise are based on comparative operating statements, instead of on financial statements only, as was too often the case in the past. With the financial statement, of course, as the necessary supporting evidence, this new policy should fortify the lending banker, who has heretofore found the customary reluctance on the part of borrowers to furnish income statements a serious handicap in judging requests for loans. Practically every business man knows how much he himself depends on his month-to-month operating statement to guide him in the conduct of his business. In other words, the operating statement is actually the pulse of his business, for it shows almost instantly various little items here and there that need correcting. Otherwise such items might go on unobserved until they had grown to a considerable size. And, of course, all such items are vitally concerned in the establishment of bank credits.

Form of Income Statements.—Bankers too often find that income statements state accounts and set forth results in a form to which no accredited certified public accountant could certify without modification or adjustment. In sum, a great many concerns state their income accounts incorrectly. This naturally tends to put the banks on their guard when making their investigations; and because of this, banks are encouraging their depositors to use uniform statements of profit and loss. In Figure 31 is the form recommended by the Federal Reserve Board which contains the essential items for a complete statement.

The wide variation in the presentation of profit and loss data is something of a problem to the lending banker, but as recommended by the accountants, it is generally accepted practice to prepare income accounts in what may be called the narrative form as distinguished from the account form. Study of the illustrative statement is suggested, the gross sales or earnings are stated, deductions are made, and extraordinary items of income are added. Those interested are enabled to read the statement as a continuous story of what has been done. The story should unfold itself so that no effort is required on the part of the banker and no undue calculation need be made to comprehend each step and the final result.

By way of contrast, the account form, referred to above, is shown in Figure 32. It is the condensed profit and loss statement approved for firms and individuals by the Illinois Bankers' Association. It is of interest to note that it contains net sales or gross earnings on the credit side of the account, and costs, expense, losses, etc., on the debit side. The balance is brought down as net income or deficit.

While much good can come from studying the actual results of a company's financial operations throughout the year, still, under the present wide latitude used in the method of presenting operating figures, the banker is often at a loss, in trying to arrive at the correct basis for analysis, to decide just how effec-

[Form for Profit and Loss Account.]

Comparative statement of profit and loss for three years ending .....19—.

	Year ending—		
	19—	19—	19—
Gross sales	$.....	$.....	$.....
Less outward freight, allowances, and returns			
Net sales			
Inventory beginning of year			
Purchases, net			
Less inventory end of year			
Cost of sales			
Gross profit on sales			
Selling expenses (itemized to correspond with ledger accounts kept)			
Total selling expense			
General expenses (itemized to correspond with ledger accounts kept)			
Total general expense			
Administrative expenses (itemized to correspond with ledger accounts kept)			
Total administrative expense			
Total expenses			
Net profit on sales			
Other income:			
Income from investments			
Interest on notes receivable, etc.			
Gross income			
Deductions from income:			
Interest on bonded debt			
Interest on notes payable			
Total deductions			
Net income—profit and loss			
Add special credits to profit and loss			
Deduct special charges to profit and loss			
Profit and loss for period			
Surplus beginning of period			
Dividends paid			
Surplus ending of period			

Figure 31. Profit-Loss Sheet recommended by the Federal Reserve Board

tive the management has been in its operation. But while it is true that it is difficult to realize or establish standards which will give exactly the same results in every analysis, yet what the banker wants is a scientific and reasonable interpretation of operations based upon facts intelligently classified. The borrower who states the transactions in an intelligent, scientific and readable way, is the one who is most highly regarded as a risk by the banker.

Tendency Toward Condensation.—Detailed income accounts are of service for some purposes, but they may be too cumbersome for others. Because too often one long income sheet, including all of the accounts representing expense, revenues, and net revenue facts, is prepared to cover all possible uses, there is a tendency on the part of many corporations and firms toward condensation. But while it is possible to present such information in a variety of ways, bankers want a clear statement of the past years, or a comparative statement covering the past 5 years' operations, if possible, as this permits a more useful analysis.

Purposes Served by the Income Statement.—Before going into more detailed discussion regarding the income statement, it is fitting to pause here for a moment, and consider the various purposes served by them. It is of interest to notice that there are many important purposes for which they are in demand, but only a very few of the more significant ones will be mentioned here.

Commercial Banking Uses.—First of all, it reveals to the commercial banker whether or not it is expedient to ask the borrower to pay up his loan, or whether it is safe or expedient to renew, or whether, in the first place, to loan at all.

It shows the banker the various classes of expenditures and how they may be kept in proper relationship.

Form No. 2—FIRM OR INDIVIDUAL—Manufacturer or Merchant

FORM APPROVED BY THE
ILLINOIS BANKERS' ASSOCIATION

TO

(BANK NAME IMPRINTED HERE)

Statement of.....

Business.....Address.....

For the purpose of procuring and maintaining credit from time to time in any form whatsoever with the above named Bank, for claims and demands against the undersigned, the undersigned submits the following as being a true and accurate statement of..... financial condition on the following date, and agree..... that if any change occurs that materially reduces the means or ability of the undersigned to pay all claims or demands against.....the undersigned will immediately and without delay notify the Bank; and unless the Bank is so notified, it may continue to rely upon the statement herein as a true and accurate statement of the financial condition of the undersigned:

Condition shown by.....books and inventory of.....19.....

ASSETS				LIABILITIES			
Cash on hand and in bank				Due on open accounts			
Accounts of customers (good)				Acceptances:			
Notes and acceptances of customers (good)				(1) Issued in payment for merchandise			
Merchandise (at cost):				(2) Other acceptances			
(1) Manufactured				Notes payable for merchandise			
(2) Raw material				Notes payable to own banks			
(3) Stock in process				Notes sold through brokers			
Total quick assets				Notes payable to others			
Due from partner's notes, accounts receivable, etc				Money on deposit with us			
Plant and Machinery				Other current debts (itemized)			
Furniture and Fixtures							
Real estate (value: mortgage entered in liabilities)							
Other assets (itemized)				Total current liabilities			
				Debt secured by mortgage—when due			
				Net worth			
				Reserves			
				Notes receivable and acceptances discounted or sold with endorsement or guarantee (contingent liability)			
TOTAL				TOTAL			

Between the date of the above inventory and the present time we have had no serious losses through bad debts or otherwise (except).....
.....
and our condition today is fully as good as set forth by the above figures.

Condensed Profit and Loss Statement for Fiscal Year Ending.....19....

EXPENSE		INCOME	
Cost of material or merchandise consumed		Net sales	
Actual expense of conducting business. Including rent, taxes, insurance, etc		From investments	
Salary drawn by myself (ourselves)		From discounts on purchases	
Interest on borrowed money		From other sources (itemize)	
Bad debts charged off			
Depreciation charged off			
Net profits			
TOTAL		TOTAL	

RECONCILEMENT OF NET WORTH

Net worth at close of previous fiscal year	$.....	
Less charges not applicable to current year	$.....	=$.....
Add net profits as above	$.....	=$.....
Less—Withdrawals, other than salary as above		$.....
Net worth		$.....

Figure 32a. A Profit and Loss Statement "Account Form" approved by the Illinois Bankers' Association

CONTINGENT LIABILITY.—We have no contingent liability of any kind as endorser or guarantor not noted above (except as follows):

.....

Our merchandise is insured for $..... Plant, building and machinery, $.....

Life insurance carried for $..... Beneficiary.....

None of the accounts or notes receivable included in the within statement have been assigned, pledged, or discounted (except as follows):.....

.....

No other contingent liability (except).....

Neither have any of our other assets been pledged or assigned as collateral for any of our liabilities (except as follows):.....

.....

Assets on which mortgages are a lien.....

Our partnership terminates.....

We have no interest in any other concern except (name affiliations and location).....

.....

There are no suits pending against our firm (except).....

.....

The form of obligation used in the financing of our business is the plain note of the firm (endorsed by).....

.....

None of the endorsers guarantee or endorse the paper of other concerns or individuals (except).....

.....

Outside resources of endorsers are.....

Our { commercial paper is / acceptances are } placed through (name broker or brokers).....

.....

Our books { are not / are } audited by a certified public accountant.....

The date of last audit was.....made by.....

BANK ACCOUNTS	LINES GRANTED	Under Discount on Statement Date
.....	.....	.....
.....	.....	.....
.....	.....	.....

GENERAL PARTNERS:

.....Personal worth outside of this business, $.....

.....Personal worth outside of this business, $.....

.....Personal worth outside of this business, $.....

(Please sign firm's name here).....

By.....

Date signed..... (Partner)

Figure 32b. (Reverse of form)

For Investment Purposes.—Among the various purposes to be served by the income sheet, the use of this statement is of greatest value, after the banker, to the investor himself. Like the banker in order to judge the safety of the investment offered, the investor wishes to know the results of the past year's operations; and as already stated, the safety of a loan often hinges upon the earning capacity. This fact of earning power is revealed dramatically in the properly set up income statement. Bankers and conservative investors are not satisfied to accept a mere statement of dividend rates as a basis for judging earning power where income sheets are not available or are not intelligible; they want the whole story before rendering a decision.

For the Needs of the Creditor.—Closely allied to the needs of the banker and investor are those of the creditor. An individual may wish to extend mercantile credit, may want to advance temporary funds, but hesitates to do so before going over the income statement. Such a creditor is entitled to that privilege and would be unwise in many instances to act without a close investigation of the profit and loss statement.

For the Purpose of Financing a Business.—A corporation about to float a new issue of stocks or bonds issues a prospectus for the future. The income sheet for such a purpose should be drawn up in such a form as to show the amount of income which would have been available for that particular class of security in the past. On the basis of such a statement, the prospective banker or buyer can reasonably judge the amount of risk involved. The price, borrowers find, yielded on such an issue can be materially raised on the basis of adequate information pertaining to earnings over what it would be without it.

For Use in Selling a Business.—The importance of the income statement when selling out a business is obvious. The question may arise: Will the owners sell for the book value, or

will they want a premium for the effort they have put in during the past? The earnings as set forth in the income statement tell such a vivid story and give such a complete answer in some cases, that further investigation is hardly more than perfunctory.

For Use of a Board of Directors.—For the board of directors the income statement is also important. What they must know and want is the comparisons of gross revenues with preceding years and likewise the amount of expenses, possibly itemized by departments or functions. Some of the questions that may be asked and answers found for them in the analysis of the income statement are as follows:

1. Is it possible to continue operations?
2. Is it advisable to increase the rate of production?
3. What are the fixed charges, percentage, etc., as compared to the total revenue?

Obviously, the manager requires a more extensive analysis of operating accounts, revenues, and expenses than the banker who ordinarily does not go into the intricacy of cost accounting unless he risks losing money. The banker may try to assist in righting matters, and may recommend an industrial engineering concern to assist in finding the difficulty.

Income Statement and the Borrower.—The importance the banker attaches to the income statement has already been emphasized; the significance of form, too, has been touched upon; and in the last section the various purposes for which it may be used to advantage were outlined. It is now proposed to go into the matter of presentation and review some of the salient points which are essential to decide whether or not the borrower is making or losing money.

From what has been previously said it is perfectly natural for the banker to wish to know whether the borrower is making or losing money. Therefore, the borrower's auditor should set

up the profit and loss statement to reveal this in sufficient detail. Indeed, a comparison should be made with several previous years. Gross income from sales in the usual course of business should be shown separately from income or from other sources, as we shall presently bring out. Also income resulting from cash discounts should be shown separately. Among other important essential points bearing on commercial credit, the following need particular emphasis:

1. Under no circumstance should the sale of capital assets be included in the profit and loss statement.
2. It is considered good accounting and banking practice to deduct from gross sales any amount resulting from cancellations or defective merchandise, as this conveys valuable information to the banker, as we shall presently see in a more detailed discussion.
3. The statement should include every item of expense, write-offs, depreciation.
4. The borrower's auditor should take care to see that a different method of bookkeeping or of taking inventory does not show a false profit.
5. It should be ascertained whether there are any special contracts soon to expire which have shown large profits in the past, and, if so, call attention to the fact in the report presented to the banker.

Some Income Statement Definitions.—In order to obtain a keener appreciation of the foregoing and of what is to follow, it is essential to define and outline just what profits are; and explain the relationship between earned profits and extraordinary profits.

For the purposes of this treatise the term net profits may be defined as the earnings of the proprietary interest after all prior contractual payments and accruals have been duly satisfied. When a corporation has been first organized, the proprietary interest is represented by the capital stock. The additions to the proprietary interest from year to year are

credited to the surplus account, so that the proprietary interest of a corporation which has been in operation for a period of time is represented by the capital stock plus the surplus. The periodic additions to surplus from year to year represent increases in the proprietary interest or in the stockholder's interest.

The increase in the proprietary interest due to the business operations for which a concern is organized is referred to as the profits from operation.

There are also sources of income indirectly associated with regular operations, such as investments in related enterprises or incidental rentals and earnings. These incomes are generally designated as other income; and as suggested above, are set forth under a separate heading on the income statement. The term "net profits" is used to designate the balance after incidental and interest expense deductions are made from the total income resulting from the addition of other income to profits from operation. These net profits, however, generally mean the ordinary net profits. Profits from the sale of fixed assets or any extraordinary profit are frequently carried to the surplus account. The total net profits, however, would include the extraordinary net profits and hence comprise the total net increase in the proprietary interest.

It would be impracticable, in the short space allotted here to go into a detailed discussion of all the transactions entering into the composition of the profit and loss statement, but there are certain principles to be kept in view that are of interest to the banker passing on a loan and to the borrower, which are briefly outlined below.

Sales.—What is the sales price per unit of product sold? If this is too much in comparison with competitive articles, like for like, the natural tendency will be a decline in sales volume and an increased operating cost per unit. As a consequence, a decrease in net profit will be the result.

Another important item is concerned with old accounts. The relation of net sales to unpaid customers' accounts as shown on the balance sheet is very important to the banker, as from this ratio the average age of the unpaid accounts can be estimated. Old unpaid accounts out of proportion to the volume of business transacted will mean requests for extensions of loans at maturity or possibly worse.

Again, if the volume of sales is small in proportion to the capital invested in the enterprise, the net result is very apt to be a poor risk. If the capital invested in the enterprise is not in the bank, or in accounts receivable or some quick turning investments, the amount in inventories or in permanent form is undoubtedly excessive. In the one case, the result will be a shrinkage because of obsolete stock or at least a burdensome carrying charge; in the other case, the cost of operations will be abnormal.

Another consideration bearing on the safety of the risk relates to the matter of future bookings. The future bookings at the close of the fiscal year should be looked into, as a comparison of orders on hand with corresponding periods of other years furnishes the investigating banker with an idea of the concern's business outlook.

Returns and Allowances.—The returns and allowances have a commercial bearing on the borrower. Experience shows that it is important to watch returns and allowances carefully, as they should not be out of proportion to the sales. Moreover, if the correct ratio to sales is not maintained, the following factors should be investigated:

The satisfactoriness of the product
The delivery service
Servicing of the product
Methods of distribution
Padded sales

The unit value of returns and allowances is of importance in showing the shrinkage in the unit sales price to arrive at the net sales price for comparison with the prices of competitive articles.

Cost of Sales.—When going over the borrower's profit and loss statement, sales costs are significant. Labor is the most expensive element of cost of most industries, and many a poor statement has been turned in for a commercial loan that failed to make the grade because labor cost prevented the possibility of a satisfactory showing.

This applies to both the manufacturing and retail branches. It is for this reason that the control of the direct labor expended on any product often means the difference between a profit and a loss on the income and expense statement. As a consequence the two relations of this factor, the proportion to sales and the proportion to cost of production, should be watched carefully by both the borrower and his banker. The ratios will vary in different industries, but the variation should be small in the same industry where labor conditions are similar.

Again, it is found that the material used often affects the borrower's chances of making creditable progress. The material used bears a very definite relation to the inventories as shown on the balance sheet. A computation of the turnover will show whether an unnecessary carrying charge is causing a cramped financial condition. If such is the case perhaps certain portions of the inventories should be liquidated by the disposal of out-of-style merchandise or obsolete stock. The case is cited of one large shoe company which found itself carrying too heavy an inventory. It then reduced the amount by $100,000 and yet was able to do a greater volume of business than before the reduction was made. It thereby made a great saving in ridding itself of old and unnecessary stock, and became a better banking risk because it had more liquid capital to put into other more productive uses.

Gross Profit on Sales.—In order to show the lending banker a good income statement the gross profits must be ample. The gross profits should not be less than the proportion of sales usually obtained in the industry being reviewed. Moreover, the relation of gross profits to the net working capital is also of importance as it may reveal unsound financing. When the commercial banker wishes to note the result, he deducts the cost of sales from the net sales and the difference should give him the gross profits. If he finds the business is only a marginal producer, he may decide its future does not warrant the bank's confidence, realizing that the companies which make only passable progress in fair business conditions often lose out when unfavorable circumstances arise.

Operating Expenses.—Among the more important elements of operating expenses to be watched from the lending banker's viewpoint are the relations to sales and cost of production of: indirect labor; rent; depreciation; insurance.

As for indirect labor, if excessive, it may mean a labor cost out of proportion, not only to the volume of sales in a retail establishment, but to the volume of production in a manufacturing establishment. The rental charge may be more than the volume and gross profits warrant, and prove a serious handicap to the company to make satisfactory headway. Again, depreciation may not be charged in sufficient amount, and hence there will be insufficient provision for replacement. As for insurance, if sufficient amount is not carried, the question arises, how will the loans be liquidated in case of fire? The premium charge to expense will assist the banker in forming a conclusion as to whether sufficient insurance is carried.

Selling Expense.—Selling expense, too, is carefully scrutinized by the commercial loaning officer. The gross profit less operating expenses may be sufficient to please the most conservative, but if the cost of distributing the product is excessive, the

net result will not be a good financial risk. How much per dollar of sales is expended in selling the product? The reply is often the difference between a commercial and a non-commercial loaning proposition.

Administration.—Administration policies, too, often prove significant in studying the income statement. When administration expenses are found to be seriously out of line, it may mean a turn-down for credit. Any business to be a good financial risk should be economically administered. Consequently the officers' salaries, salaries of office employes, traveling expenses, and entertainment expenses should be a reasonable proportion of sales.

Sometimes the interest paid items on loans made elsewhere than at the subject bank give a good insight into the cost of financing the enterprise, and if excessive may cause the banker to refuse what might otherwise be a good loan.

Net Profit.—Last of all, and most important item to look for, of course, is the net profit. Unless the net profit is a reasonable percentage on the investment, the risk is a poor one. The percentage of net profit to net working capital is also of interest and the banker looks to these relationships closely before granting a loan, realizing that abnormal conditions would in the end make it impossible to pay off the bank obligations.

Some General Considerations.—When it is found that high operating costs are due to obsolescence of machinery or the carrying of out-of-fashion or shop-worn merchandise, the banker may decide that what is needed is new capital to bring production up-to-date, or a general house-cleaning to get rid of the worthless accumulation of depreciated merchandise. Again, the banker may find high operating costs may be due to poor production methods or uneconomical practices of management. In either case, unless the margin on the product is a large one, bankers, before loaning, often prescribe a "shake-up," to bring

a readjustment about before committing themselves in the matter of accommodations. Because of the importance of sound management in safeguarding bank loans, some space will be given to the business experts and their co-operation with bankers and borrowers in bringing production out of losses, and progress and profits out of stagnation and inefficient management.

Business Expert's Aid in Showing Better Profit and Loss Statement.—Thus far in this chapter attention has been devoted to the form, the purpose, and the presentation of the income statement. Consideration has been given to the various important items appearing on the income sheet, and some suggestions regarding the banker's reactions toward them have been made. Now, for the sake of discussion, a few questions pertaining to operations will be asked. What may the borrower do when his entire operations show a loss? What may he do when important divisions of an enterprise show a deficit? How can business managers remedy the unprofitable features of their business? What constructive measures can be taken in the direction of up-building the company's affairs? These are some of the questions commercial borrowers would like answered.

If the financial heads of a business are unable to answer the above questions, there is but one inevitable result—a continuous deficit, with a consequent loss in the banker's confidence, until the working capital is exhausted, and then failure. Because the problem of financial adjustment in a business is one which requires perspective, and because the co-ordination of commercial operations often requires the unbiased, impartial viewpoint of some one outside the business, whose specialized knowledge of the industry can bring the experience necessary to satisfactory readjustment, the banker often recommends the business expert to the borrower in trouble.

Just as the certified public accountant aids the borrower in the proper presentation of the figures, and just as the reputable

appraisal company makes possible definite valuations for the borrower, so the business expert, through a specialized knowledge of particular industries, is able to throw the torchlight of truth upon business operations, and bring success out of failure. The industrial engineer adjusts not only machines, but human relationships, all toward the end of greater efficiency and greater ultimate profit for the business man and the borrower.

Lastly, the present discussion is also concerned with a still different class of specialist, one who, while often an expert accountant, has made so intensive a study of a special industry or business as to be able, through accumulated experience, to render valuable service, not only in establishing sound merchandising policies, but in bringing about financial stability. He renders a dramatic picture of the entire business activities of the borrower through a compilation and analysis of the essential facts necessary to successful management. The great handicap under which many merchants and manufacturers operate is the lack of facts. They do not know the details of the important aspects of their business and, consequently, often do not know whether they are actually losing or making money.

How the Business Counsellor Supplies the Facts.—To supply the merchant-borrower and his banker with the facts, the efficiency experts often make arrangements to get out monthly reports in great detail which are of much value in giving a tabulated history of operations to date. Reports of this character, among other things, include the following:

1. Balance Sheet
2. Profit and Loss Statement
3. Comparative Income and Expense Statement
4. Departmental Gross Profit
5. Comparative Departmental Gross Profit Statement
6. Inventory Comparison
7. Proof of Inventory
8. Turnover Statement

JEWELRY STORE
LA PORTE, INDIANA
COMPARATIVE INCOME AND EXPENSE STATEMENT
For Two Years Ending December 31, 1925 and 1924

	1925	% of Sales	1924	% of Sales
SALES	$61,465.40	100.0%	$53,695.72	100.0%
COST OF GOODS SOLD	36,182.15	58.9%	30,525.53	56.8%
GROSS PROFIT	$25,283.25	41.1%	$23,170.19	43.2%
EXPENSES				
Selling Salaries	$ 6,581.00	10.7%	$ 5,819.50	10.9%
Buying	1,300.00	2.1%	1,305.00	2.4%
Advertising	3,305.35	5.4%	3,666.97	6.8%
Delivery	1.50	—	2.35	—
Freight and Express	312.73	.5%	284.92	.5%
Store Supplies	541.03	.9%	869.41	1.6%
War Tax	636.54	1.0%	793.45	1.5%
TOTAL TRADING EXPENSES	$12,678.15	20.6%	$12,741.60	23.7%
Rent	$1,200.00	2.0%	$1,200.00	2.2%
Depreciation	1,418.27	2.3%	1,325.88	2.5%
Light, Heat and Power	750.22	1.2%	615.65	1.2%
Cleaning	181.84	.3%	174.01	.3%
Taxes	1,056.02	1.7%	706.07	1.3%
Insurance (Except Life)	450.31	.7%	502.16	.9%
Repairs	—	—	179.58	.3%
TOTAL FIXED EXPENSES	$ 5,056.66	8.2%	$ 4,703.35	8.7%
General Expense	$ 757.84	1.2%	$ 492.09	.9%
Management	1,320.00	2.2%	1,349.05	2.5%
Office Exp. and Salaries	1,772.31	2.9%	1,209.20	2.3%
Postage and Phones	319.00	.5%	215.14	.4%
Interest Paid	877.21	1.4%	1,478.40	2.8%
Bad Debts	516.55	.8%	240.00	.5%
Donations	66.75	.1%	124.50	.2%
Short and Over (Cash)	1,046.04	1.7%	125.21	.2%
Refunds	66.00	.1%	22.75	—
TOTAL OVERHEAD EXPENSES	$ 4,649.62	7.5%	$ 5,005.92	9.4%
TOTAL OPERATING EXPENSES	$22,384.43	36.3%	$22,450.87	41.8%
NET PROFIT ON MERCHANDISE	$ 2,898.82	4.8%	$ 719.32	1.4%
OTHER INCOME				
Discount Earned	$ 613.41	1.0%	$ 554.38	1.0%
Rent Earned	655.00	1.1%	315.00	.6%
Bad Debt Collections	47.75	.1%	81.10	.2%
Miscellaneous Gains	140.10	.2%	152.22	.3%
Jewelry Repairs	1,021.37	1.6%	973.90	1.8%
Watch Repairs	2,388.50	3.9%	1,993.05	3.6%
TOTAL	$ 4,866.13	7.9%	$ 4,069.65	7.5%
Less Adjustments	404.46	.7%	760.78	1.4%
TOTAL OTHER INCOME	$ 4,461.67	7.2%	$ 3,308.87	6.1%
NET PROFIT FOR YEAR	$ 7,360.49	12.0%	$ 4,028.19	7.5%

Figure 33. Comparative Income and Expense Statement

The foregoing indicates the thoroughness with which business experts go into operations. There is shown in Figure 33 a comparative income and expense statement. It tells clearly the direction the business is heading; and the tabulated com-

JEWELRY STORE
LA PORTE, INDIANA
COMPARATIVE DEPARTMENTAL GROSS PROFIT STATEMENT
For Two Years Ending December 31, 1924 and 1925

Dept.	Kind of Merchandise	Year	% of Total	Sales	Cost of Sales	Gross Profit	% of Sales
A	Jewelry	1924	17.0%	$ 9,125.49	$ 5,838.64	$ 3,286.85	36.0%
		1925	17.0%	10,450.36	5,614.34	4,836.02	46.3%
B	Watches and Clocks	1924	26.0%	13,932.37	8,045.01	5,887.36	42.3%
		1925	26.5%	16,378.11	9,958.74	6,419.37	39.3%
C	Silverware	1924	11.9%	6,373.13	4,144.89	2,228.24	35.8%
		1925	10.0%	6,080.53	4,128.57	1,951.96	32.0%
D	Diamonds	1924	29.1%	15,603.30	7,829.85	7,773.45	49.8%
		1925	31.5%	19,399.11	10,222.09	9,177.02	47.4%
E	Umbrellas, Leather Gd.	1924	1.8%	973.15	643.84	329.31	33.9%
		1925	2.0%	1,200.35	772.36	427.99	35.7%
F	Pens and Pencils	1924	1.8%	986.48	695.59	290.89	29.6%
		1925	1.4%	871.85	707.73	164.12	18.8%
G	Glassware	1924	5.6%	3,026.91	1,632.94	1,393.97	46.0%
		1925	4.3%	2,617.72	1,628.10	989.62	37.8%
H	Novelties	1924	5.2%	2,814.44	1,164.92	1,649.52	58.5%
		1925	5.4%	3,308.72	2,522.38	786.34	23.8%
I	Ivory	1924	1.6%	860.45	529.85	330.60	38.2%
		1925	1.9%	1,158.65	627.84	530.81	45.8%
	TOTAL	1924	100.0%	$53,695.72	$30,525.53	$23,170.19	43.2%
		1925	100.0%	$61,465.40	$36,182.15	$25,283.25	41.0%

Figure 34. Comparative Gross Profit Statement

parisons visualize for the borrower just how his current progress compares with the preceding year.

In Figure 34 there is a comparative gross profit statement. It is helpful in that it shows a comparison of sales by departments for the years 1924-25, and the gross profit of each department, and the percentage of total sales of each department to the entire volume of business transacted. An analysis shows

the business executive which lines are bringing in the most gross profit.

Figure 35 shows a turnover statement. Much has been said of the importance of turnover in relation to profitable operation. As exhibited here the expert shows the borrower-operator his turnover by departments in dollars and percentages. By con-

JEWELRY STORE
LA PORTE, INDIANA
TURNOVER STATEMENT
For Year Ending December 31, 1925

DEPT.	AVERAGE RETAIL STOCK		SALES FOR YEAR		RATE OF TURNOVER	
	Amount	% Total	Amount	% Total	1925	1924
A	$15,439.56	23.2%	$10,450.36	17.0%	.7 Times	.6 Times
B	13,550.30	20.3%	16,378.11	26.5%	1.2 "	1.3 "
C	7,481.40	11.3%	6,080.53	10.0%	.8 "	.9 "
D	18,221.21	27.5%	19,399.11	31.5%	1.1 "	1.1 "
E	1,228.64	1.9%	1,200.35	2.0%	1.0 "	.6 "
F	696.92	1.1%	871.85	1.4%	1.3 "	1.0 "
G	4,689.28	7.1%	2,617.72	4.3%	.6 "	.7 "
H	4,101.72	6.2%	3,308.72	5.4%	.8 "	.8 "
I	947.27	1.4%	1,158.65	1.9%	1.2 "	.5 "
TOTAL	$66,356.30	100.0%	$61,465.40	100.0%	.9 Times	.9 Times

Figure 35. Comparative Turnover Statement

sulting this sheet the executive is able to see at a glance which department is liquidating and which department is slow. Such facts are of infinite value to the man at the helm of a business.

In connection with the eight illustrative statements which are above referred to, the expert includes helpful explanatory comments. He tells the why and the wherefore of his analysis, and emphasizes the points he wishes to bring out in the detailed report sheets submitted. It is surprising to many business men what a thoughtful comparative study of such reports reveals about the operation of the business down to its smallest component part.

Because they are qualified through concentrated, grounded experience in specific industries, efficiency experts are of the greatest value to the borrower and the banker in bringing to light the relationships of the different departments of a business. They thereby assist firms to a sounder financial procedure, often retrieving failure and showing profits where losses were before, thus making for safer banking commitments through an adequate knowledge of business facts.

Financial and Merchandising Charts.—It would be natural to expect that experts devoting their entire time to the accumulation, analysis, and presentation of facts pertaining to a particular type of business would be able to draw conclusions of much potential use to the business executive engaged in that special line of business, and especially to the lending banker. By securing in confidence merchandising figures from a large number of firms all engaged in the same form of business and by careful analysis and tabulation in the form of charts, the expert performs a useful service to industry.

There is perhaps no more valuable way of presenting the statistical truths of a business than by showing in graphical form the results obtained from the operations of a large number of firms from all sections of the country. Such figures give a cross-section of conditions. They make it possible for the executive to compare his own figures with the composite ones presented by the expert in the form of charts and by so doing to measure his own progress and achievement.

By way of illustrating the work carried on by business counsellors in this direction there are shown in Figures 36-41, several representative charts. These are six of a complete set of ten charts, which throw light on the operations and conditions in the retail business covered by them. They are comprehensive and "are not based upon theory, off-hand opinion, or superficial survey, but represent compilations of figures from dry goods

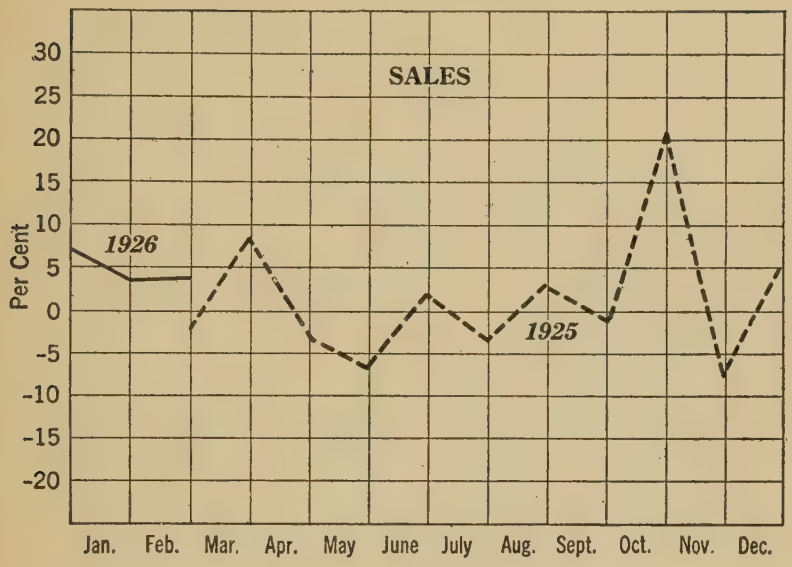

Figure 36. Chart of Sales

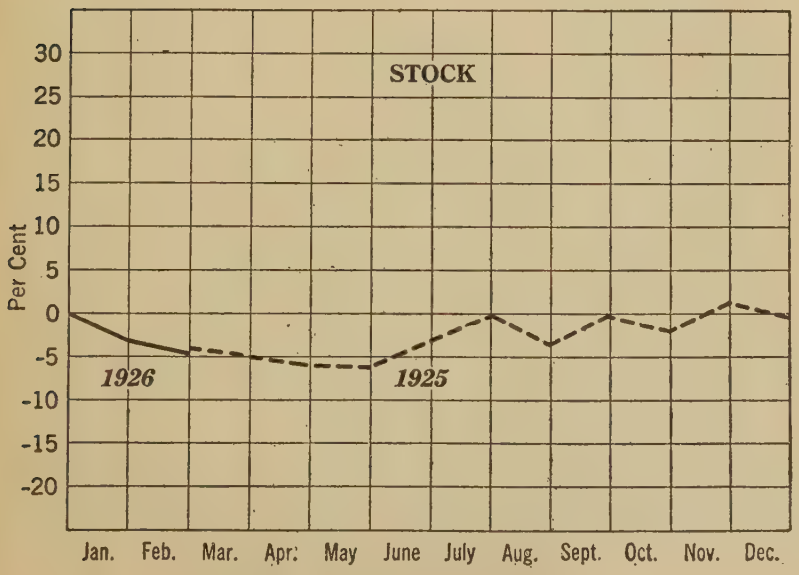

Figure 37. Chart of Stock Balance

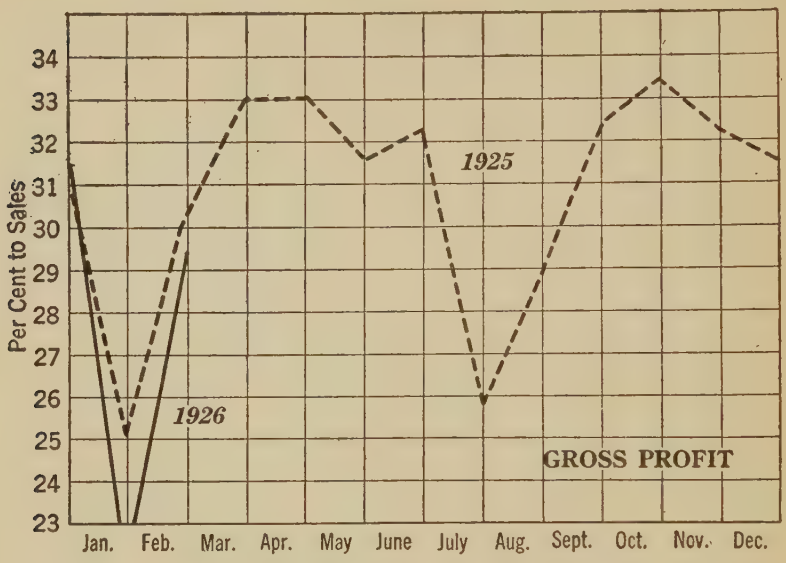

Figure 38. Chart of Gross Profit

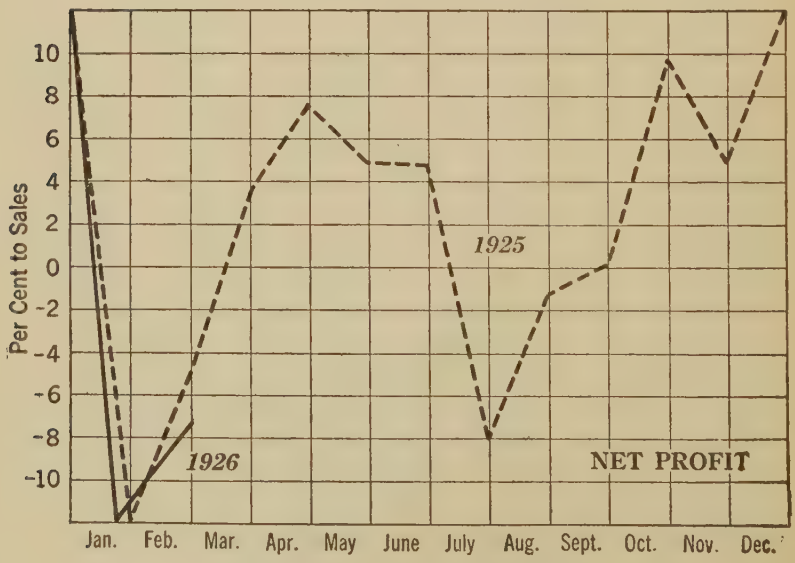

Figure 39. Chart of Net Profit

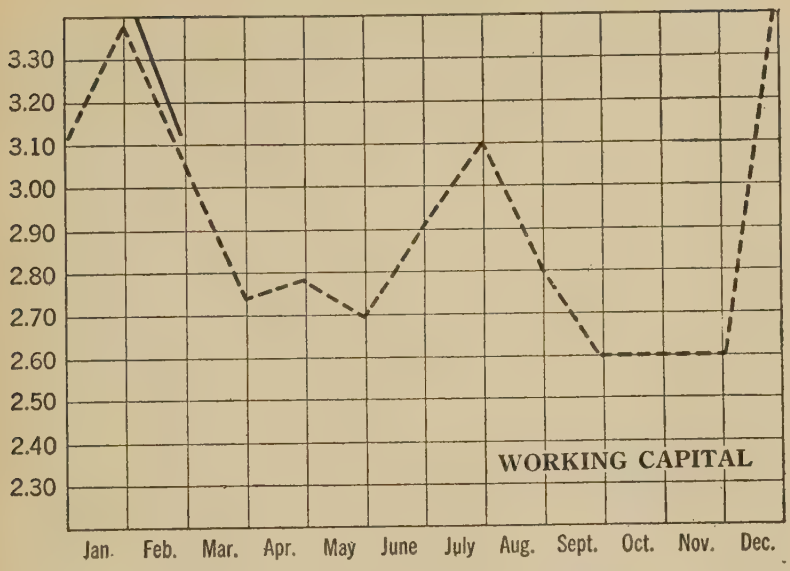

Figure 40. Chart of Working Capital

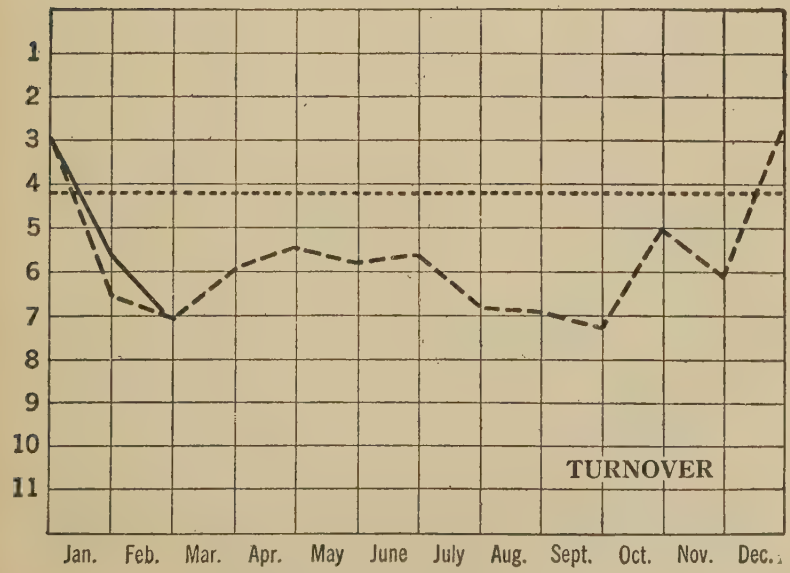

Figure 41. Chart of Turnover

The following tabulation shows the average expenses to date for the seven months period ended July 31, 1925, for all stores combined of a department stores corporation. The classification of expenses follows the audit report and is uniform for all clients. The figures represent the per cent of expenses to total sales.

EXPENSE TABLE

ACCOUNTS	Expense for Full Years		Expense for Seven Months			
			1925		1924	
	1924	1923	Yours	Aver.	Yours	Aver.
Selling Salary	7.4	6.9		8.0		7.9
Buying	1.3	1.3		1.6		1.4
Advertising	4.0	3.6		3.7		4.2
Window Trimming	—	—		.3		—
Delivery	.6	.6		.7		.7
Freight and Express	.8	.9		.9		.6
Store Supplies	.4	.4		.4		.4
Direct Dept. Expense	.8	.7		.5		.4
Work Room	—	—		.3		.5
Alterations	—	—		.1		—
Discount Allowed	—	—		.1		—
TOTAL TRADING	15.3	14.4		16.6		16.4
Rent	2.4	2.2		3.0		2.6
Depreciation	1.2	1.0		.9		.8
Light, Heat & Power	.7	.6		1.4		1.3
Taxes	.6	.6		.8		.7
Insurance (Fire & Liab.)	.5	.5		.6		.5
Repairs & Maintenance	.1	.1		.1		—
TOTAL FIXED	5.5	5.0		6.8		5.9
General Expense	2.0	1.9		1.0		1.8
Management	2.5	2.4		2.7		2.6
Office Expense & Salaries	1.7	1.4		1.7		1.7
Postage & Phones	.3	.2		.3		.3
Interest Paid	.5	.4		.5		.5
Loss on Bad Accounts	.3	.2		.3		.3
Donations	—	—		—		—
Life Insurance	—	—		—		—
Collection Expense	—	—		—		—
Professional Services	—	—		—		—
TOTAL OVERHEAD	7.3	6.5		6.5		7.2
TOTAL EXPENSES	28.1	25.9		29.9		29.5

It was possible to place the particular figures of an individual department store on the chart above and check up on the cost of doing business in that particular store.

stores in all sections of the country." [1] The ten charts cover the following subjects:

1. Sales
2. Stock
3. Gross profit
4. Net profit
5. Expenses
6. Mark-downs
7. Collections
8. Indebtedness
9. Working Capital
10. Turnover
11. Summary

It can be seen from the foregoing that the reader gets a comprehensive survey of conditions as they exist in the retail trade. They not only illustrate the trend of sales, but the financial operating conditions which prevail during the period among a substantial number of the most successful retailers throughout the country.

Lastly, table No. 10, entitled "Expense Table," is shown to bring out the close comparison in operating expense made possible by co-operating in the use of consolidated figures prepared by industrial experts. The figures include the important items of expenditures, with space for personal tabulation. Such a comparison assists the firm to form an opinion of the efficiency of its operations. The footnotes and comments furnished with tables make them clear and readable and their use should do much to assist borrowers to show better income statements, and to improve their operations generally, thereby affording a better risk for the banker.

[1] Schreffler's Reports on Retail Conditions.

CHAPTER XV

PLANNING FOR BUSINESS CONTROL

Better Co-operation Between Banker and Borrower.—Much has been made in this discussion of the importance of presenting business and financial conditions so that they are readily comprehensible. The position must be clearly outlined in order that the loaning banker may form judgments quickly and accurately upon the facts presented. Of no less importance is the need of planning for business control in order that the manufacturer or merchant may so guide the business enterprise that the results will be worthy of a banker's confidence.

Following upon the depression of 1921 the bankers became closer to their clients than perhaps at any other time in their relationship. Together they were compelled to work out the trying situations in which inflated inventories, falling prices, and reduced consumption found the merchants. As a result the old attitude of distrust toward the banker upon the part of misinformed merchants and manufacturers, on the one hand, and the aloofness upon the part of the banker on the other, were forgotten and they became fused in their relationship in a new spirit of co-operation.

Today, the relation between the banker and his customers is not unlike that of a competent physician and a wise patient. The depositors have come to have implicit faith in their banker; and in order that he may better help them, have come to confide in him all their financial problems. Moreover, the merchants have come to know and appreciate the candor and sympathetic co-operation of bankers, who, in their new trust, have been able to bring about a sound financial readjustment

by assisting and encouraging their depositors in realizing business control.

Scientific Management.—Of the many things the banker and his customers learned in going together through periods of transition and depression, none was more obvious than the need for scientific management in business. In assisting their depositors to outline their financial program they learned that there were successful formulas which could be applied to business. The reactions from the application of given formulas or rules, it was found, produced much the same results in business that a chemist working with formulas would get in a laboratory. Given certain conditions, applying practical, known regulations to business problems, resulted in profitable operation. This truth having been discovered, the problem has resolved itself to applying the right formulas to the right business so that the maximum returns may be realized.

In order to get at a successful business formula bankers learned that business operations had to be broken up into units and studied separately. The findings proved to the banker's conclusion that the terms, sales, administrative and general expense, were only useful when analyzed in small units, and each item of expense compared with the standard set in the composite yardstick of the industry of which the concern forms one unit.

As a means of determining and helping those in charge of its management to visualize the efficiency of an enterprise, the bankers suggested a closer co-operation with industrial engineers in conducting business operations, accurately appraised valuations of fixed assets and inventories, and the use of graphic charts as a means of assisting business managers in attaining more adequate business control.

By the use of graphs, forming composite pictures of the progress of an enterprise, executives can demonstrate to the satisfaction of all interested parties the exact condition of a

business. But the construction of graphs calls for facts and figures. Bankers urged their depositors to keep more adequate records of sales, receivables, payables, and itemized costs of production, so that week by week and month by month the relation of all the divisions of the business may be interpreted through comparison by means of graphic charts, and the conclusions formed enable more effective operating and financial control.

Estimated Budgets.—In order to realize the most from an enterprise and to enable it to borrow on its statement from the banks, it was found that objectives, or estimated budgets, were a valuable help in establishing a basis of operation for every department of a business. An estimate of net sales for the year, cost of sales, yearly inventory requirements, of working capital needs and administrative expense must be worked out in advance, with sufficient elasticity of operation that all functions of the business be co-ordinated toward efficient business control.

The main object and purpose of the budget is to secure internal control of a business, and it is held that the manufacturer has taken a big step in the direction of business progress and banking credit, if, at the beginning of the year, instead of entering the new period without plans or definite purpose, he computes to the best of his ability the probable business for the year, the costs of manufacture, the financial requirements, and the estimated profit. This holds true even if estimates vary widely from the results thereafter realized from operation.

A few of the advantages that are claimed for budget making may be summarized as follows:

1. Everyone in the establishment will have a definite goal for attainment.
2. Sales and production plans can be co-ordinated with financial resources.

3. More continuous operation and greater regularity of employment can be provided.
4. Products, processes and equipment can be standardized.
5. Costs can be used for purposes of control rather than as historical information.
6. Reduction of waste will be encouraged by the maintenance of better balanced inventories, by instituting wage payments based upon results, by definitely assigning responsibility for expenditures.
7. Taken in conjunction with the business cycle, the budget will give warning when to be cautious and the cue when to go forward with manufacturing plans.
8. At all times the budget serves as a measuring stick to compare actual performances with promises and standards, showing not only what may be done but what should be done.
9. It provides for increase or decrease in capital structure before such time as "financial embarrassment or unprofitable application of funds" overtakes a business.

Bankers are generally of the opinion that the wise use of a properly constructed budget should be helpful to the manufacturing establishment using it, and may be helpful to the bank from which such a concern desires to secure loans. It enables the banker to check up future plans with the manufacturer's past performance, and thus aids in giving the banker a concrete picture of the reasonable credit needs of the manufacturer over a given period of time.

Budgeting the Finances.—In the past there has been a seeming reluctance on the part of business men to establish financial goals or programs, to definitely plan ahead what they can or expect to do with their financial resources. There is a widespread feeling that if only sales can be made, all else, including financing, will somehow take care of itself. Yet there are limits to the strains to which the financial resources of a company can be safely subjected, and it is possible to ascer-

tain such as definitely, or almost as definitely, as one can the capacity of a machine or the tensile strength of a piece of steel. In fact, one of the chief objects of the budget is to show as nearly automatically as possible just how far capital will safely go and the point beyond which new capital will be necessary.

It has already been stated that the available capital of an enterprise, that is, its outstanding capital stock, earned surplus and funded obligations, are distributable in ratios that will vary from industry to industry and from plant to plant among buildings and equipment, inventories, cash on hand, and the net current receivables over current payables. As previously pointed out, unless these ratios are in proper proportion, the financial structure will be thrown out of line, and the most will not be realized from the capital invested. Indeed, to the extent to which equipment is utilized, to the extent that inventories of raw and finished materials are in line with sales and production programs, to the extent that work in progress is accelerated, to the extent that collections are made promptly and within reasonable limits of time after shipment, the maximum use of capital will be approximated.

As outlined by the Department of Manufacture of the Chamber of Commerce of the United States, some of the following essentials of a budget system are:

1. Careful estimate of sales based upon previous year's experience, tempered by the immediate business situation.
2. Scheduling of production in keeping with sales estimates.
3. Careful gauging of material requirements.
4. Establishment of standards of labor performance.
5. Careful analysis of expenses, with limits set for auxiliary services such as power, maintenance and delivery.
6. Provision for funds to carry through projected sales and production programs.
7. Provision for checking and revising standards by performances.
8. Predetermining of profits and losses.

In applying the foregoing essentials to any concern, it must be borne in mind that there is nothing inflexible about the budget program. Where budget making has been best developed, minimum and maximum and intermediate programs are provided for, to which operations shift as the developing volume of business indicates expedient. Each month the budget is checked in the terms of actual performance, and such revisions and changes as appear necessary are then made in the budget program. Budgets are valuable therefore because they show the executive what to expect continuously throughout the year when certain things occur. The mere attempt to forecast future progress, therefore, is only part of the function and value of the budget.

Summary of Financial Planning.—It is desirable to summarize briefly some of the suggestions bankers endorse and urge merchants and borrowers to follow in financial planning.

First, the most should be made of capital resources. This means that new buildings should not be acquired if space in old ones is available or can be allocated more efficiently; that additional equipment should not be purchased if better scheduling will reduce the idleness of machines and allow for larger and more constant operations; that excess purchases of materials and excess employment of labor should be avoided; that goods should be sent through the factory expeditiously; that collections should be placed on a sound and reasonably prompt basis.

Secondly, it should be clearly realized that short-time obligations are not a permanent contribution to capital and that manufacturers should hold themselves in readiness to liquidate, if and when required, by at least maintaining a comfortable margin of cash and liquid accounts receivable over current indebtedness. Short-term obligations ought to bear a definite relationship to the capital of a company or rather to those assets which are properly coverable by short-term borrowing, and any unwarranted increase in this ratio should be regarded

with alarm. The liquidation of debt ought to go hand in hand with the liquidation of inventories or accounts receivable, and it is a danger signal if a given debt should carry beyond the liquidation of the inventory or other transactions for which it was incurred. The practice of some bankers of requiring a 60- to 90-day liquidation from non-seasonal as well as seasonal lines is a conservative influence and has a salutary effect even though this requirement may mean only a rotation of loans among other banks.

Thirdly and most important of all, there should be self-imposed limits of business to be undertaken in any one year upon available capital. A business can be organized upon one of two bases—the minimum plan or the maximum plan. The minimum plan calls for a volume of sales sufficient to yield a fair return on investment. If an amount of business above this minimum is secured, the elasticity of the organization is depended upon to handle this additional volume without extra expense. The starting point, however, is not how much business can be secured but how much business is needed for a fair and healthy profit.[1]

The maximum plan calls for all the business that can be had. It is assumed that the buying power of the American public is inexhaustible and that the demand can be created where it does not exist. Astounding successes have been made by intrepid American business men, who sensing a demand long before it was evident, have embarked upon vast programs of expansion only to have the sales in a relatively short time catch up with their facilities. Immense fortunes and dominating positions in industry have thus been secured, but for every success, there have been a dozen failures.

Mushroom expansion is spectacular but too often disastrous. Large-scale enterprise, while not dangerous, when the balance is preserved, becomes a menace when there is a glorifica-

[1] Budgeting for Business Control, pp. 18-36, Department of Manufacture, Chamber of Commerce, U. S. A.

tion of growth for growth's sake, the plunging into grandiose development projects on a superficial examination of the probable demand and without a thorough-going appraisement of financial resources. Enterprises have gone into receivership or have been thrown permanently out of balance, eking out meager earnings and making indifferent progress, because they have been fashioned on too large a scale. Designed to furnish all the goods the market might crave, regardless of the burden imposed on the working capital, such enterprises have never quite caught up with excessive inventories, expensive buildings, and over-expanded equipment.

Too few manufacturers or merchants who have been accustomed to borrow from banks, have been willing to impose limits, based primarily upon a fair return on investment, to the amount of goods they will sell and produce. A minimum financial program will not build fortunes in a day, but with reasonably skilled management, its adoption ought to lead to steady and substantial progress, and in the long run, to greater net profits than those enjoyed by the average business. Organized to do a minimum volume that will yield a fair return, there will be ample room for ingenuity and aggressiveness to handle a percentage of additional business, with substantially the same equipment and the same forces. Proceeding in a conservative manner, with debts under control and sales and production attuned to finances, with growth proportioned to accumulated surplus and net earnings, few situations ought, or can arise that will greatly disturb such an enterprise. Growth is desirable, but growth beyond the strength of organization is dangerous and undermines banking confidence and the investor's trust in the management.

Illustrating the Financial Goal.—A prominent manufacturer of farm implements, in an effort to place before that industry something concrete and definite by way of a financial goal, used the following illustration.

Finding that there is now employed in the agricultural implement industry $1.35 of available capital for each dollar of sales, this manufacturer estimates a well-balanced farm machinery company would require $1,200,000 fully paid up capital stock, together with the usual seasonal borrowing, to take care of an $800,000 minimum and a $1,000,000 maximum sales volume. From the information at hand drawn from a number of companies over a period of years, he estimates that the $1,200,000 capital would be properly distributed as follows:

Assets	Amount	Per Cent of Available Capital	Per Cent of $800,000 Sales
Plant	$ 420,000	35	52½
Inventory	400,000	33 1/3	50
Receivables	240,000	20	30
Cash	140,000	11 2/3	17½
Total	$1,200,000	100	150

Liabilities	
Capital stock	$1,200,000
Payables, at beginning and end of year	None
Surplus	As accumulated
Reserves	As accumulated

The manufacturer then proposes two plans of operation, a maximum plan and a minimum plan. The maximum plan contemplated establishes the production and sales organizations on the basis of maximum volume of sales possible and in the event the maximum sales are not attained, then the net profits are less than expected, while if sales are materially in excess of the maximum, then the finances of the company will be strained.

The minimum plan is based on organizing for a minimum volume of sales on which a satisfactory profit can be made on the capital employed. The minimum plan is predicated on the belief that there are few salesmen who cannot increase their sales 25% in favorable years over normal experience, and that there are few branch houses that cannot handle an increase of 25% with their storage and clerical organizations, should the business be available. In other words, the minimum plan

makes full provision for taking advantage of the elasticity in the organization, particularly in the sales and production departments, while the maximum plan takes no advantage of this elasticity, thus making almost certain large losses in earnings if the business does not come up to the maximum amount of sales. Illustrating this point, the manufacturer uses the following exhibits:

Minimum Plan of Organization

If organized on a $800,000 minimum sales basis, the year's operations would be somewhat as follows:

	Per Cent	Amount
Total cost of operations, including—		
Cost of production	.....	.....
Sales expense	.....	.....
General and other expenses (including taxes)	89.75	$718,000
Interest paid	.....	.....
Net profit	10.25	82,000

Should sales exceed expectations and reach $1,000,000 (cared for in part by reduction of inventory and in part by increased production), the showing would be approximately as follows:

	Per Cent	Amount
Net profit on $800,000 sales as shown above (before taking into account savings as outlined below)	10.25	$ 82,000
Plus increased earnings due to larger volume on account of:		
Amount saved by having greater production over which to distribute overhead	4.00%	.....
Having a larger sales volume over which to distribute sales expense	3.00	
Total saving	7.00%	
Deduct possible increase in interest charges incident to increased volume	.90	
Net saving	6.10%	61,000
Total net profit on $1,000,000		$143,000

Note: On an increased volume of sales, no saving is estimated on "General and other expenses," but allowance is made for these to increase in the same ratio on the $1,000,000 volume as obtained on the $800,000 minimum.

Maximum Plan of Organization

If organized on a $1,000,000 maximum sales basis, the year's operations would be somewhat as follows:

	Per Cent	Amount
Total cost of operations, including—		
Cost of production	.....	.....
Sales expenses, general and other expenses (including taxes)	86.65	$866,500
Interest paid	.....	.....
Net profit	13.35	133,500

The foregoing illustration is an interesting attempt to formulate a financial program that will yield a reasonable profit on a balanced volume of business.

Should sales for any reason reach only $800,000, the showing would be as follows:

	%	Amount
Net profit on $1,000,000 sales as shown above	13.35	$133,500
Less decreased earnings due entirely to lessened sales on account of:		
Reduced factory operations increasing cost of production through having to carry full overheads on decreased volume	4.00%	
Having to carry a maximum sales expense that could not be reduced in time to make material savings	3.75	
General expense and other expenses that could not be decreased (including taxes) would add in percentage not less than	2.50	
Total decrease in earning percentage	10.25%	
Deduct possible saving in interest, which saving is doubtful	.90	
Total increase cost of carrying on the business on sales volume of $800,000	9.35	93,500
Leaving net profit	4.00%	$ 40,000
Net loss in earnings due to decreased volume when maintaining full maximum organization		$ 93,500

Mechanism of the Financial Budget.—The purpose of the financial budget is to give the management in advance an estimate of the cash receipts and disbursements so that arrangements can be made for needed financial assistance. There is no fixed or standard period for which such a budget should be prepared. That will vary with the requirements and circumstances of different businesses. Financial budgets have been found that were prepared a year ahead and with considerable accuracy.

The financial budget, however, is customarily prepared 3 months in advance and checked monthly to see how closely performances coincide with estimates and to take care of such revisions as may be required. Through the courtesy of one of the large rubber companies 2 forms (Figures 42 and 43) used in the preparation of their financial budget are given: (1) A

COMPARISON OF ACTUAL EXPENDITURES WITH CASH FORECAST

.....Factory for the month of.....192.....

CLASSIFICATION	FORECAST	ACTUAL EXPENDITURES	GAIN (BLACK) LOSS (RED)
1. Salaries			
2. Wages			
3. Sub-Total			
4. Body fabrics—Cord			
5. Body fabrics—Square woven			
6. Cotton fabrics, cotton yarns, etc.			
7. Footwear fabrics—Woolen and woolen mixtures			
8. Clothing fabrics—Woolen and woolen mixtures			
9. Leather			
10. Reclaimed stock			
11. Chemicals, pigments, etc.			
12. Wire			
13. Tire valves			
14. Hose nozzles, couplings, fittings, etc.			
15. Buckles, rivets, buttons, and grommets			
16. Sub-total			
17. Cartons, labels, paper containers, etc.			
18. Packing cases, shooks, etc.			
19. Coal and fuel oil			
20. Maintenance, materials and shop materials			
21. Lasts, moulds, cores, forms			
22. Restaurant supplies			
23. Office furniture and equipment			
24. Printing, stationery and office supplies			
25. All other materials and supplies			
26. Sub-total			
27. Inward freight			
28. Light, heat, water and power purchased			
29. Insurance			
30. Royalties			
31. Rentals			
32. Taxes			
33. Telephone and telegraph			
34. Traveling expenses			
35. All other expense items			
36. Sub-total			
37. Miscellaneous factory collections (Red)			
38. Sub-total (Items 3–16–26–36 less 37)			
39. Salaries—Sales			
40. Outward freight			
41. All other selling expenses			
42. Grand total of all operating expenditures (Items 38–41, inc.)			
43. Construction (Pay-rolls and materials)			

Figure 42. A Form used by a Large Rubber Company in Preparation of the Financial Budget

CONSOLIDATED STATEMENT OF ACTUAL CASH RECEIPTS AND DISBURSEMENTS COMPARED WITH FORECAST

Date.....

CLASSIFICATION	FORECAST	ACTUAL	GAIN (BLACK) LOSS (RED)
Collections:			
.....			
.....			
.....			
Total collections $.....			
Disbursements:			
Requirements for operating....			
.....			
.....			
.....			
Sub-total.....			
Operating $.....			
Selling expenses.....			
Sub-total selling $.....			
.....			
Total disbursements $.....			
.....			
Net balance from operating:			
Corporate requirements.....			
.....			
.....			
.....			
.....			
Total $.....			
Balance available:			
Plant additions $.....			
.....			
.....			
Total $.....			
Net balance $.....			

Figure 43. Another Form used by the Large Rubber Company in the Preparation of the Financial Budget

comparison of actual expenditures with cash forecasts. (2) A consolidated statement of actual cash receipts and disbursements compared with forecasts.

In each case the form used is exactly the same as that used in the forecast. It will be noted that the form cited selects a particular month and gives the actual and estimated figures, while the forecast gives only the estimates for 3 months.

Through the 2 forms, budget estimates and actual results can be balanced against total cash disbursements.

Cash will come in from accounts receivable and notes receivable at hand at the beginning, and from additional sales made during the budget period. In small businesses it is easy to know at first hand those accounts and notes receivable which will be paid. In larger businesses it will be necessary to rely on ratios, based upon past experience, of collections to sales or receivables. Disbursements will be necessary to pay maturing notes and due accounts, and to take care of operations over the budget period. Salaries, wages and supplies of the various departments, materials for manufacturing, freight, and fixed expenses, such as taxes, insurance, interest and rent all must be estimated, not from the point of view of justly allocating such to cost but from the point of view of the time of actual payment. If construction work is under way, that too must be taken into consideration; if dividends are payable or corporate bonds redeemable, these also must be cared for in the financial budget. The excess of estimated expenditures over estimated receipts, as finally passed upon, will indicate the extent of the financial requirements to be met by arrangements for loans or sale of stock.

How Graphic Charts Aid the Borrower—Sales.—From what has already been disclosed it is apparent that carrying out the budget system makes necessary the compilation of the facts and figures essential to correct planning. In order to take advantage of the figures and to impress the exact financial

condition of a company upon his mind, the executive, armed with the required data, is in a position to set them up in graphs or charts. Graphic charts are valuable in that they depict clearly the financial situation, and can be applied to advantage to the different departments of business with excellent results in reaching budgeted objectives, and attaining the desired financial control.

Consider, for example, the use of graphs in relation to sales. Suppose a sales executive is to sell a specified volume of goods each month, and has a limited amount of money budgeted to accomplish his purpose. As he progresses with his sales campaign he leaves behind him a sales record in dollars, representing a given volume of goods sold. In order to know just what course to pursue, he must be informed daily as to the progress he is making.

Figure 44 shows a graphic interpretation of the daily average sales of a manufacturing concern. Business was taken covering a ten-day period, and the curve plotted by dividing through by 10, establishing the points as orders came in. This gave the executive his daily average record and helped him in his sales operations in the following respects.

It showed the sales manager that there was a fall off in orders between the first and the tenth of the month. Visualizing this graphically, it brought home to him the need for stimulating his sales operations around the first of the month, and to do this he sent out sales letters which proved effective in realizing his sales quota.

It is interesting to note also that the letters when sent out at this time produced the most satisfactory results. At the bottom of Figure 44 will be found the letters, C. L., or circular letters. A graphic study of results attained over a period of years showed the executive of this company that it paid him only to send out his letters beginning about August of each year, and continuing through the year until the following March.

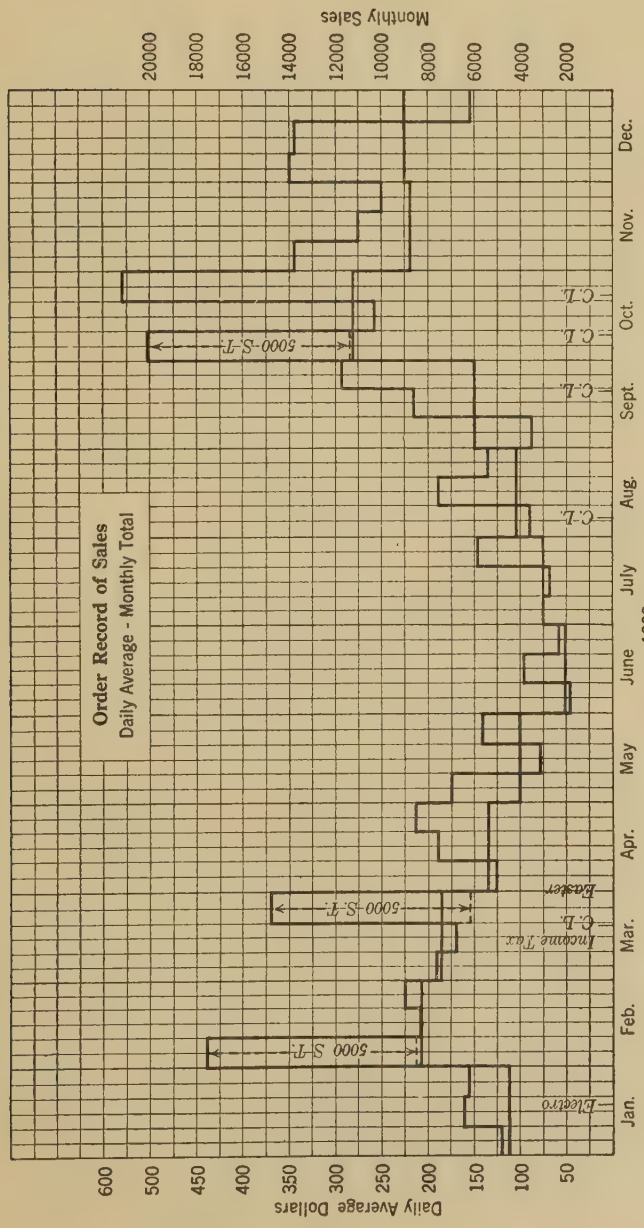

Figure 44. Chart Showing Daily Average Monthly Order Record of Sales

In studying the same chart for the whole year 1923, it will be noted that in 4 instances during the period sales jumped considerably above normal, and made that an especially profitable year in the company's operations.

Suppose now that the sales manager wishes to know the trend of his average monthly sales over a period of, say, 6 years. To do this he totals his sales for the 12 month period, from January 1 to January 1 of each year, and divides through by 12. This establishes his first point on his graph. Then he takes the total sales for the year, one month later, from February 1 to February 1, dividing through again by 12, and so on, until he has plotted his curve, as shown in graph Figure 45. The value of this chart to the sales manager lies in the clear picture it gives him of his general sales trend covering several years, and reflects accurately the progress of the business.

Suppose, now, it is desired to compare the sales of a concern with the general business trend to observe its advance over a period of several years as compared with business conditions as a whole. In Figure 45 the executive lays out Babson's Chart, shown by line "A." Then he plots sales in billions in 165 localities, as revealed by curve "B." If the business manager finds that the trend of his business is downward as compared with the general business trend as shown by the Babson's Chart, there is an indication that his business has fallen down, and that his sales promotion work has possibly not been as strong as it might be. Investigation may show that the firm's credit policy has been too severe, or that the salesmen are not offered sufficient inducement to offset the sales resistance to the product due to competition.

Referring again to the chart in Figure 45, the banker or merchant can tell how the orders compare with sales for the period. It will be noted that during most of 1923 and the first 6 months of 1924 orders were in excess of sales. Business became so brisk that orders rose above sales until after July,

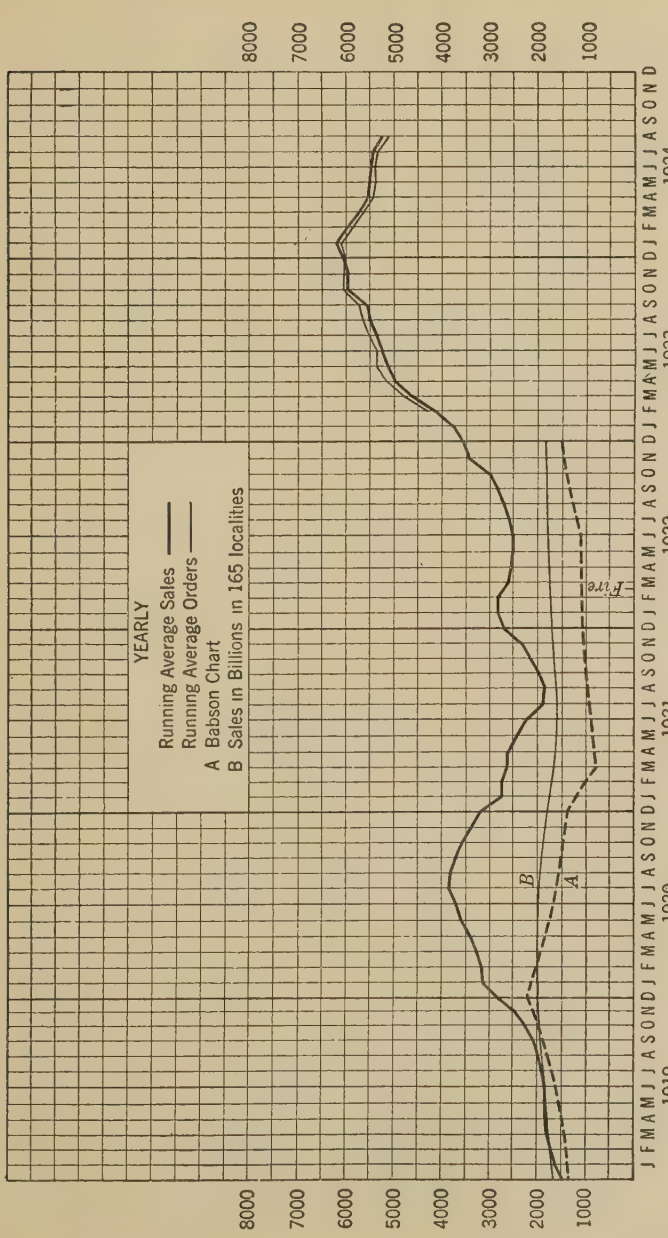

Figure 45. Provides Graphic Record of Sales of a Manufacturing Concern

1924, when business generally began to fall off and sales and orders both declined.

Suppose a banker is contemplating an extension of credit to a concern and wishes to see how its business compared with the general business trend. It will be noted in Figure 45 that this manufacturing company's trend corresponded with the general depression in 1921, followed by a gradual rise in its sales curve to the peak of 1924, showing an excess of business at that time over that of the year 1920. Suppose that the graph, instead of showing a general upward trend, fell off sharply. The banker or merchant might draw the conclusion that the company was losing ground, and that an investigation into the management might reveal some "dead timber" which prevented a wholesome progress. The value of such significant interpretations proves to be immeasurable to the thinking banker and merchant who can make a proper analysis, and go back of the graphical history itself, prove the facts and figures which are therein reflected and by so doing, see the business, not as they would like to see it, but as it really is.

Use of Graphs in Production Control.—Having discussed sales, it will not be illogical to consider some of the means suggested by bankers of attaining management control of production through the use of graphs. First, how is a manufacturer going to determine manufacturing costs? To ascertain these he must break up his general expense into labor and materials and keep accurate check on expenditures. To accomplish this he arranges his factory control so that time-study analysis can be realized, and the exact amount of time it takes to carry out each operation of the business can be ascertained. An accurate cost system will tell him just how he stands on expenditures for materials, and a perpetual inventory will enable him to maintain a flexible co-ordinated management.

One of the most effective means of picturing just what expenses amount to for a manufacturing concern is in the use

of a graphic chart, showing a plotted curve representing accounts payable month by month in dollars. In the graph chart in Figure 46 there is shown a record of the accounts payable of a manufacturing company for 6 months on the daily unit basis. It will be noted that the payables fluctuated monthly, and increased steadily during the period. The value of this

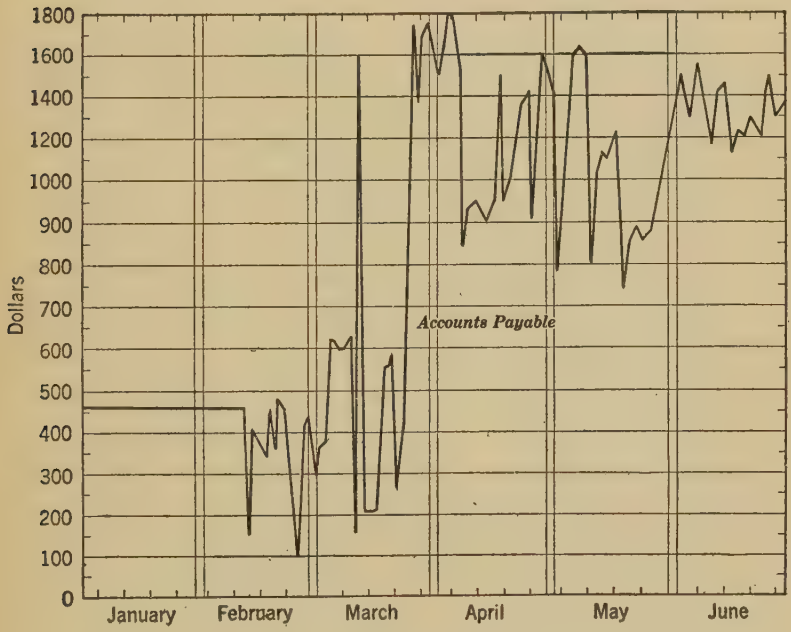

Figure 46. Graph Showing Accounts Payable by Months

chart to the manufacturer lies in the distinct visualization of the amount owed by the corporation, and the general trend of these obligations.

It is of interest to note the high peak of payables during the middle of March, 1924. At this time the business was in the early stages of its development, and a large expense for materials was needed to start production. As the concern became larger, sales increased, and production was consequently

augmented; the payables, it will be noted, climbed upward in "saw-tooth" fashion, until the end of June, at which time the general average for the month was around $1,400, or more than $1,000 over the month of February of the same year.

If the production manager's objective depends on the quantities and types of goods to be turned out, in order to reach his objective he must co-ordinate his department with the fiscal end of the business.

If the executive in charge of production is operating on a dollar unit of production, he knows that for every unit of goods produced he will require a specified amount of working capital to meet his costs. The amount of this working capital will depend, aside from the capital stock in the business, upon the accounts and notes receivable and upon cash in banks.

Charting Cash Position.—Bankers have often experienced difficulty in interesting their clients in the importance of maintaining a strong cash position, commensurate with the set-up of the business, and for this reason encourage their depositors to use graphs, as a means of showing an exact picture of the relative positions of the current assets. It will be observed in the graph in Figure 47 that accounts receivable, notes receivable, and cash in banks are all charted or graphically pictured separately so that their exact relative strength may be noted from month to month.

A comparison of this chart and the chart in Figure 46 will give an interesting sidelight on the condition of the business. It is significant that accounts and notes receivable and cash in banks increased gradually during the first half of the year; and that while accounts payable revealed a high peak for March, the receivables showed a decrease. This is of value to the banker and the merchant making an analysis of the condition of the business, in that it checks up the payables chart with the one showing the current assets, by reason of the fact that during March, as already stated, the company was just enter-

ing upon active manufacture of their product with little income, and consequent heavy payables for the purchase of materials.

The graph chart in Figure 47 shows also that notes receivable progressed fairly evenly, and that cash balances revealed but a slight increase during the 6 months period. The reasons

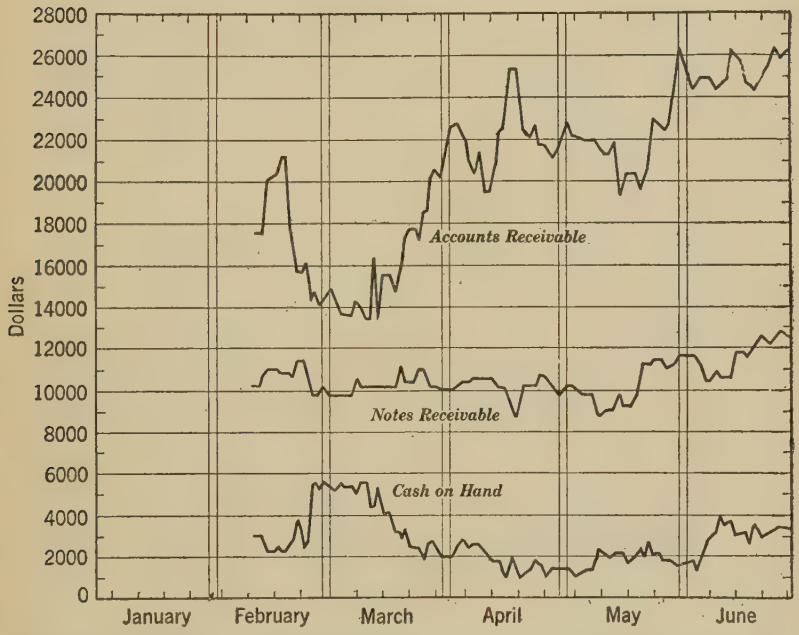

Figure 47. Graph Showing Notes Receivable, Accounts Receivable and Cash

for this were as follows. The working capital requirements of the company were so heavy incident to launching a new product that after paying bills at the end of the month there was little cash left available for bank balances. Notes receivable remained about the same also, as only a limited percentage of the product sold as represented in notes, and hence the rise of the graph representing notes would be more gradual, and with less

fluctuations than in the case of the graph representing the receivables on open accounts.

Thoughtful bankers encourage graphic records of this sort, as they reveal to the merchant or manufacturer the trend of his business, and make for effective working capital control. The business executive knows just where he stands from the point of view of cash resources from day to day and week to week, and can co-ordinate his production and sales making for efficient management control.

Suppose, for example, more goods were produced for a given month than was anticipated. Naturally, the budget expense will have to be revised to meet the cost of increased production. Suppose, again, that less goods were produced than was expected; that sales did not necessitate as much production. Then the budget would have to be contracted, and the graph would show a downward trend, or a decrease in payables would be revealed on the chart. Perhaps, too, there would be temporarily more cash in banks, for the above reason, and the graph representing this item would show a corresponding rise.

A thoughtful study will make clear to the banker or merchant using graphs as a means of business control, that plant extension and sales expansion can be undertaken only to the extent to which such activities can be sustained by the balance sheet position.

By making graphical records of some of the main items on the working capital side of the financial statement, the business executive and banker can analyze and visualize their true position, and may be astonished to learn, after study of the graphs, that their financial position is not as good as was expected.

Chart of Distribution.—One of the outstanding problems confronting industrial progress today is that centering around the question of distribution. Increasing competition and the high middlemen's profit, as compared with what it used to be,

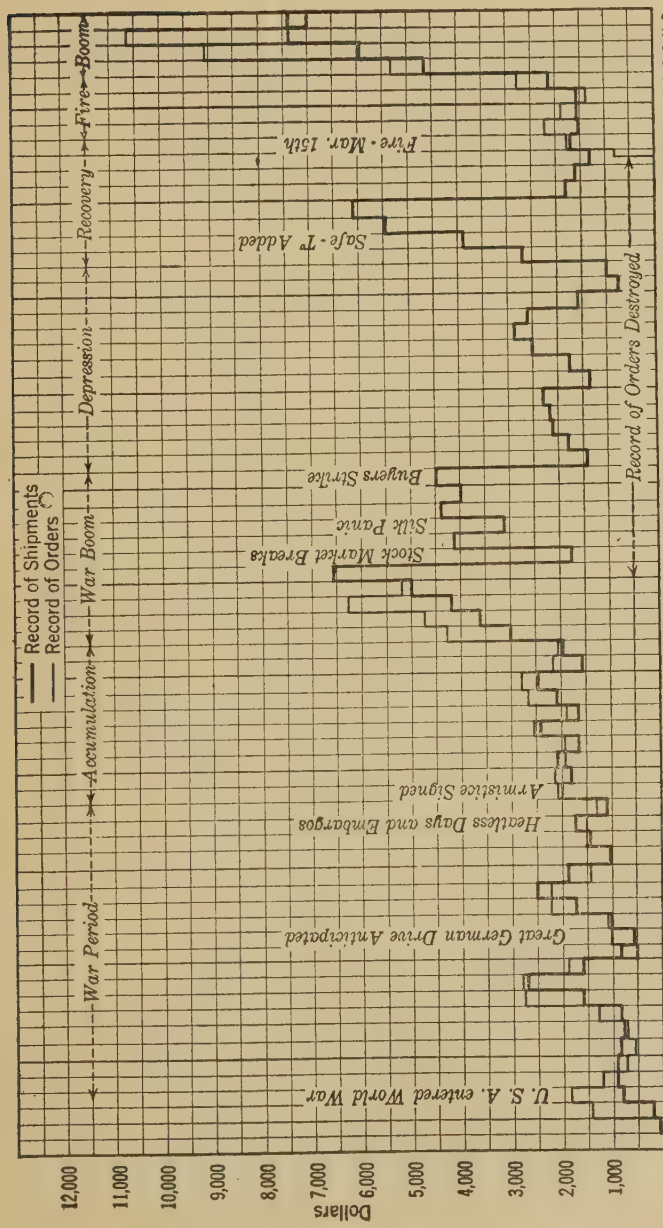

Figure 48. Chart Showing the Record of Shipments and Orders of a Small Manufacturing Concern. Covers a five-year period and gives a vivid picture of fluctuations in the business

on all articles manufactured, makes it essential that adequate means be found for getting products into the hands of the ultimate consumers at a more reasonable price.

An interesting analysis of distribution is found in the chart in Figure 48, representing graphically a record of shipments and orders covering a five-year period. Here the progress of a small manufacturing enterprise is shown, which commenced operations on an invested capital of only $2,500 and gradually increased the volume of its orders and shipments, as shown in the graph, to the point in 1922 when they reached their peak of shipments of around $10,600 for the month of December of that year.

To the thoughtful banker and merchant the graph in Figure 48 offers an interesting graphic history, which shows clearly the progress of the concern through the "ups and downs" of 5 successive years of operation. The influence of business conditions on this enterprise is interestingly revealed as follows: The favorable effect of the United States entering the war, the stimulation through the "War Days," the rise in business after the Armistice, and the consequent shrinkage in orders following the break in the stock market. Then the depressions of 1920-21 are shown, succeeded by a series of fluctuations, until the peak of 1922. A study of such a graphic chart over a period of years gives one an idea of the stability of an organization, what might be called the continuity of its business trend, and in a measure reflects the effectiveness of the management in times of change and emergency.

A northern manufacturer of meat-cutting machines found it of value to plot a curve showing a graphic record of machines shipped and returned. The chart in Figure 49 is valuable in reflecting the effectiveness of the management, and especially the success of the production sales plans as reflected in the shipments shown. A sharp rise in the curve for machines returned for the month of December is doubtless due to the fact that it being at the close of the year, customers were

"cleaning house," and consequently such machines as were defective came back in greater numbers during that month. When the curve moves upward steadily in proportion to the curve representing shipments, it becomes apparent to the management that their product is not up to standard, and a realization of this by a study of the chart will doubtless make it profitable to continue their efforts to perfect their product.

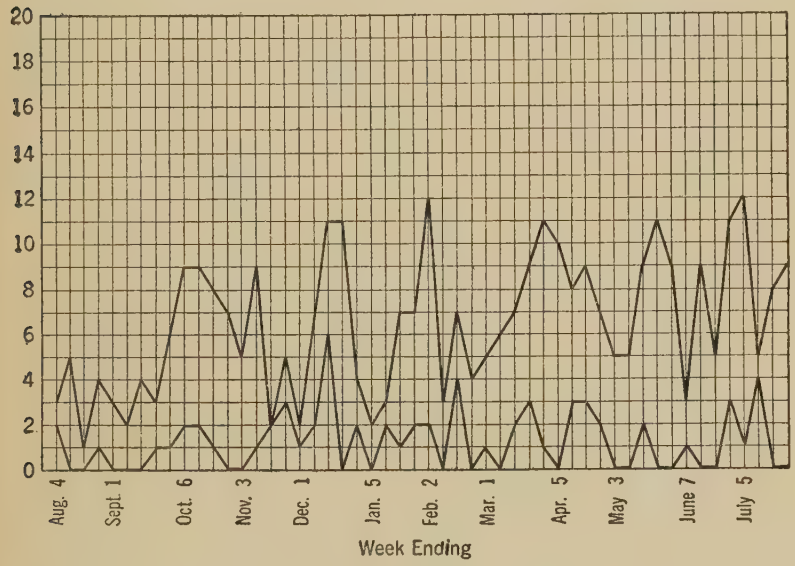

Figure 49. Chart Showing Machines Shipped and Returned

Charting Profits.—Since the economic reason for operating a business is profit, in order that merchants and manufacturers may progress with increased confidence, bankers have encouraged their depositors to chart their profits each year, so that by comparison they may establish standards by which their progress may be judged.

The efficiency in the operation of any enterprise is reflected in its net profits, and a graphical chart showing the results of a year's business is most helpful in bringing about a sound

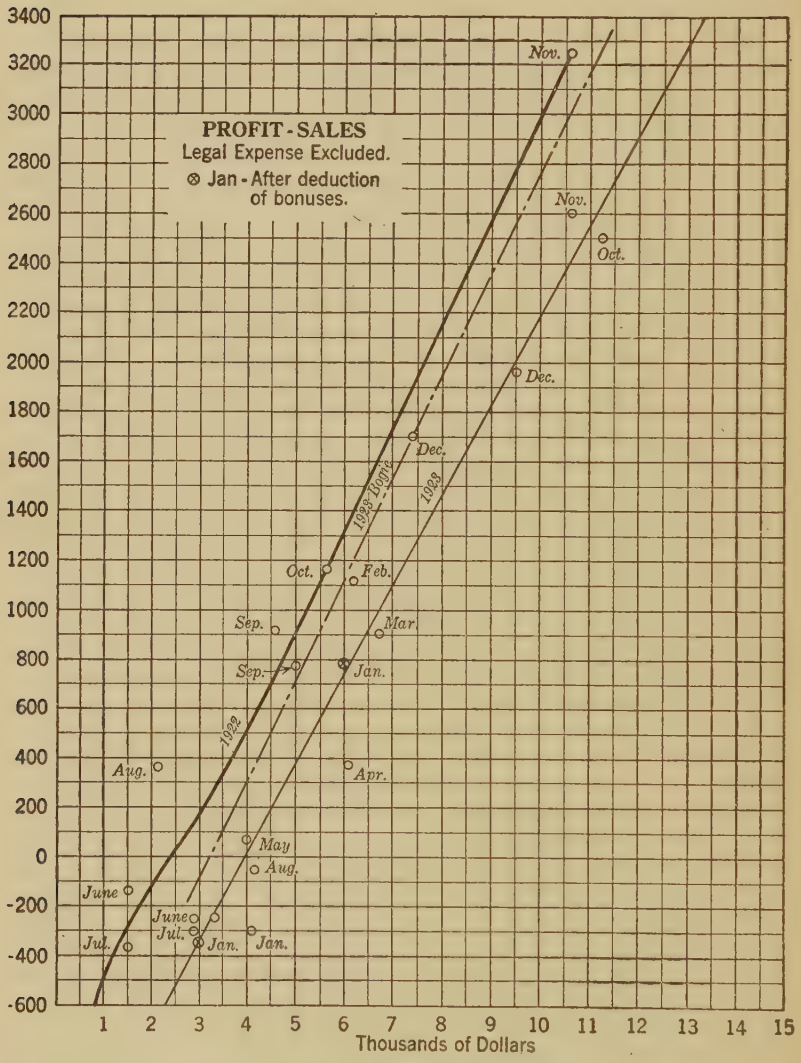

Figure 50. "Bogey" Chart Profit-Sales

appreciation of the year's operations. In the graph chart in Figure 50 the dark heavy line "O" shows the dividing line between profit and loss. The merchandise sold in November, 1923, as indicated by the chart, was a little more than $10,500. The profit realized was just $2,600. It is interesting to note that while in November, 1922, only $10,500 worth of goods was also sold, a $3,200 monthly profit was realized, or a larger profit on the same volume of goods sold. The manufacturer using this chart explained that increasing costs of materials and labor made it necessary to sell more merchandise to realize the same profit.

Bankers recommend the use of graphic analysis of profits as especially helpful in establishing a "bogey," a financial mark to "shoot" at. The merchant, it will be observed, set up a "bogey" line for estimated profits for the year 1923, but failed to make the profits expected, owing to increased costs and competitive conditions which made it impossible to operate with the anticipated margin of increment.

As a result of the close co-operation of bankers and merchants during the past few years, there has come about a better understanding and a new spirit of helpfulness. It is the belief of many thinking bankers and merchants that statistics are today where electricity was at the time of Benjamin Franklin. By encouraging their depositors in higher standards of conducting business, by urging a closer analysis of business problems, the best interests of both are served.

CHAPTER XVI

EFFECT OF COMPETITION IN NEGOTIATION OF UNSECURED LOANS

Place of Competition in the Negotiation of Unsecured Loans.—Unquestionably competition has come to have a pronounced effect on the negotiation of commercial loans. With the industrial development throughout the country, banks have sprung up on all sides, and in some cities like New York and Detroit they are so plentiful with branches in all parts of the city, one almost associates them with a chain of drug stores. The real truth of the matter is that conditions in densely populated metropolitan districts warrant a large number of banks, and it is actually profitable for banks to compete for new business by reason of the tremendous increase each year in our national wealth.

The significance of this truth is best reflected in the growth of total deposits of the banks in all parts of the country. To be specific, in the year 1925, the consolidated statement for the Chicago banks alone showed that total deposits increased $124,173,000, cash resources increased $21,522,000, and savings deposits increased $24,140,000.

Advantages of Competition to the Borrower.—Since the law of supply and demand operates universally, it is not illogical to suggest here its effects on the commercial borrower. With a number of banks competing vigorously for substantial commercial account balances, it might be expected that this law would operate, and its reactions tend to favor the borrower from several angles. The prospective borrower desires a number of things from a bank, but primarily he is interested in credit.

1. More Money.—In cases arising where competition is keen, it is not uncommon for a commercial company to present its statement in confidence to the loan officials of several different banks, consider their reactions toward the statement, adjudge their knowledge of the business, get their offer of a line of credit, and then, depending upon the circumstances of the negotiations, make their choice.

Just how far competition affects the borrower in the line of credit he is able to obtain will depend upon a number of conditions. At this point it is fitting to emphasize the importance of knowing how thoroughly familiar the bank's loaning officials are with the borrower's line of business. If the loaning officer is conversant with the applicant's type of enterprise, it is apt to react in favor of the borrower's request for credit accommodations. The banker's knowledge of certain kinds of business enables him at times, by reason of his experience, to go farther in his negotiations for an account.

For the large borrower, thought should be given to the resources of the bank. Since it is necessary for national banks to limit their loans to not more than 10% of the bank's combined capital and surplus, for the sake of protection the extent of a bank's resources may be a very vital consideration. Moreover, the laws pertaining to state banks differ widely regarding limitations on bank loans, hence the borrower must necessarily consider the type of bank and judge whether it will be large enough to care for his maximum credit needs, so that it will not be necessary to resort prematurely to other banks for accommodations. Thus the conservative borrower, in the face of competition, weighs all these considerations and chooses the bank he believes is best suited to his needs.

2. Better Terms.—When a strong company whose financial standing is well-known opens a new branch in a financial center, it is a frequent occurrence for several banks to solicit the business. In some instances they are advised by a cor-

respondent bank of the intentions of a particular concern to open new offices, and often telegrams are sent out in advance asking for the business, and offering to be of any service possible. When overtures are made by several banks to one such concern, it is possible for the executive in charge of finances to check the different banks against each other and thereby benefit by competition. Some of the terms which may be affected to some extent by competition are the following.

In matters pertaining to exchange for collection of bills of lading, customers' drafts, trade acceptances, etc., not including checks, because on those items the rates are established by the various clearing house associations, the borrower might be benefited by competitive conditions. Suppose there are 4 banks after an account. Suppose, for the purposes of discussion, that 2 of the banks are very large banks, having correspondents all over the country. With many cities on their par list, that is, points where they have connections which will clear their items at par direct, it is possible for them to save a considerable sum on exchange for their depositors.

Now, suppose the other 2 banks are smaller banks with but one or two out-of-town correspondent banks. Naturally, they will not be able to clear at par their items on distant points, and consequently will have to charge their customers for the amount of this collection charge. For this reason the smaller banks are at a disadvantage in competing with larger banks in matters of collections at distant points, due to the loss of time through inability to send items direct. Thus when the borrower has an opportunity to check up rates of exchange and the time it takes to make collections with several banks, he may be able to realize a considerable saving in many instances by depositing with the bank which has the most par points, and has the most satisfactory arrangements for the economical handling of the business.

The commercial borrower also gets better interest rates when competition is keen. Banks as far as possible concur in

the matter of interest rates charged on loans, but in some financial centers the larger institutions, having great resources and much money to loan out, are in a position to offer lower interest rates than is the case with the smaller and younger institutions with less resources and smaller loans. The commercial borrower solicited by several institutions, by quoting the rate offered him by one bank gets a similar rate from a competitor up to a certain point, but the borrower when making arrangements for accommodations with a new bank may get more favorable rates of interest as a result of competition. Circumstances often alter the case. Just how far competition affects interest rates is a question. It is an economic fact, however, that when money is plentiful, especially in cases where banks have large surplus funds, money is cheap to loan out.

In some instances the large metropolitan banks find deposits coming in from their correspondent banks so heavy that they become burdened and reduce their rates in consequence, offering rates of interest which are lower than those of the smaller, rural banks. Thus the borrower may be benefited by competitive condition in interest rates.

Competition is undoubtedly an advantage to the pioneer borrower. By that is meant the young, unestablished business enterprises which do not present a very strong statement, but which show signs of progress. Banks compete for young businesses, because it is the young business of today which is the big business of tomorrow. Of course, there are many exceptions, but out of every 100 new undertakings started there will be a percentage which will ultimately be valuable depositors, and for these the competition among bankers is keen.

Possibly the best way to illustrate the effect competition has on the pioneer borrower would be to analyze the loans which banks charge off at the end of the fiscal year. In many instances such an analysis would show that the bank had loaned its resources to companies which were still going through a period of early development. If this is true, why do banks do

this? Because banks realize they are a factor in upbuilding their communities. They feel it their duty to try to foster neighborhood industries. In many cases their funds would be infinitely more safe out on call, in conservative bonds, or in the vaults. Still, with a keen desire to help the young borrower, banks compete with one another for business, and often grant credit to firms which are really speculative in character, and which while not bad risks, are too often borderline cases which banks would be justified in leaving alone. To do so, however, would often cast a reflection upon them for not standing behind community enterprises and thus compromise the interests of the bank.

Looked at in its broadest aspects, it is a good thing that banks are willing to take the interest they do and the risks they run to foster industry. Without it the commercial borrower would be greatly hampered in his growth. The banks are able to carry on a forward-looking policy in competing for new business, largely because the returns on banking capital are substantial, which offset, in part, the losses experienced in unfortunate loans.

3. More Gratuitous Services.—With growing competition among banks the commercial borrower receives more gratuitous services. He is presented with handsome leather-bound pass-books. He is given beautifully engraved or lithographed bank checks which cost the banks exorbitant prices. Then, too, customers expect to have their checks specially imprinted by the bank. Some banks bear this expense in the face of keen competition, though it is in reality in some cases an imposition.

Along with these services the borrower benefits by the free services rendered by the credit department. He uses the banks' agency services, Dun's or Bradstreet's. He receives free counsel from the trust department; too often free appraisals on real estate loans from the real estate loan department of a bank. He

expects unexpired time free on his box rental, and all down the line the commercial borrower profits at the banks' expense partially by reason of competition.

4. Effect of Competition on the Scope of a Bank's Services.—With the growth of large-scale business enterprise, and the increasing development of our financial structure, the scope of banking services has gradually widened with the years until today they touch in some form almost every kind of business operation. Today the banks have a many-sided business. They are really engaged in many lines of activity, but are all interlocked together—a composite entity, a corporate organism complete in itself, providing every financial service in one institution.

Competition is partly responsible for this. In striving to meet the ever-growing needs of industry, the banks have vied with each other in providing facilities which would come up to the expectations of their depositors. Thus the commercial borrower benefits through a widened scope of banking facilities. Just how far competition and the commercial demands of today have extended the scope of the bank's services is best illustrated by the following advertisement of a leading Chicago trust company:

1. Takes charge of securities for safe-keeping.
2. Collects coupons, mortgage interest, rent or dividends and disposes of the proceeds as directed.
3. Makes federal income tax ownership certificates.
4. Makes delivery of securities under your direction.
5. Advises patrons of called bonds, stock subscriptions, rights, etc.
6. Makes special investigations for corporations looking toward the establishment of modern systems of operation.
7. At the special request of a concern points out weak spots in the financial statement, suggesting methods of improvement.

Another trust company in the East, the Equitable Trust of New York, in the publicity department alone, offers to do the following for its clients: "Prepares for customers digest of state and federal laws relating to taxation, government requirements, etc., issues pamphlets on financial and economic subjects of timely interest. Furnishes information regarding foreign trade: markets, names of buyers, credit ratings, tariffs, export methods, etc."

Disadvantages of Competition for the Borrower.—It is thus seen that the borrower enjoys many advantages as a result of competition. With these advantages there are also some unavoidable disadvantages. Some of the more important of these are as follows:

1. Tends to Split Accounts.—It frequently occurs that a firm or individual, due to competition, will have its bank balances so split up with deposits in different institutions as to be of little value to any of them. Looked at from a commercial banking point of view, any firm whose daily average balance is less than $1,000 is not considered very substantial, although it may be sound. And it is not holding out a very strong inducement to the bank to extend credit accommodations. Hence the firm would be better off were it to maintain but one commercial balance, and give the single bank a chance to make some money on the account.

Too often the individual who is at the head of some young business which carries modest balances, is induced indirectly through banking competition to carry his personal checking account near his home rather than near to his place of business. Thus the bank handling the small firm account does not have the advantage of the personal balance which might prove to be even greater, in some instances, than the company balance. The result is to weaken the concern's standing with its borrowing bank, which may, because it does not have all the busi-

ness, be less interested in assisting the company by extending credit for the reason that it is not profitable for them to do so.

2. Tends to Encourage Over-Expansion.—It has already been pointed out how under competitive conditions the borrower in some cases may be able to make more liberal bank loans. While in some instances this might prove an advantage, it can also readily be seen that it might prove a disadvantage. The reason for this is that competition may tend to encourage over-expansion.

Suppose, for example, a corporation has a good balance sheet, and is warranted by its size to have four banks. Suppose it borrows $100,000 from each bank. If the company carries substantial balances in each institution, and is a really worthwhile enterprise, there will be a natural tendency for competition to develop. As the corporation grows and needs more credit facilities, the banks will try to encourage it to do more business with them. In order to get the business the tendency is to offer more credit than the borrower really needs. Sometimes the pressure becomes so great that the borrower takes from the banks in unsecured loans more money than he can pay back. He borrows more heavily than he conservatively should, over-expands his business injudiciously, and in the end becomes insolvent. He has borrowed extensively from several banks, bought more merchandise than his business really needs, or produced more goods than he can sell, and when liquidation time comes is unable to clean up his loans. Then the banks have to work out a solution to get the business out of its predicament. Sometimes the enterprise will have used the funds thrust upon it by generous bankers in excessive expenditures for permanent assets such as plant investment and machinery. In such cases the process of liquidation is often a tedious one, and the well-meaning commercial borrower finds himself deeply embarrassed, simply because he has failed to appreciate the difference between working capital and fixed investment.

Suffice it to say that the borrower often learns through sad experience that to borrow money is one thing, but to pay it back is entirely another. Competition may lead bankers to encourage over-expansion in some cases, but it does not lead them toward laxity, necessarily, in the matter of liquidation of obligations. Such is the effect competition has on the borrower, who finds bankers pushing money toward him in times of prosperity, but who finds them because of the nature of their business, severe with him in the matter of liquidation during the period of their annual "clean up" of loans and in times of stringent money.

3. Tends to Encourage Bankers to Make Promises They Cannot Keep.—The wide scope of banking activities has been briefly outlined. It has been shown how competition has tended to encourage banks to give their clients general service. The question arises as to just how far the banker can go to serve his depositors. Certainly it should not be the aim of the banks to take away the responsibility of management from their clients. Yet there are many services, such as were briefly outlined earlier in this chapter, which a bank can do for its customers without over-stepping the reasonable limits.

Where the danger from too keen competition lies is in making promises of service the banker cannot keep. No bank or banker can think for its customers. Decisions cannot be made for them in regard to their problems, but advice and valuable information can be given them to help them think straight and make sound decisions. It is only when the banker suffers from misguided initiative that competition has a bad effect on the borrower, who may get the impression that the bank wants to operate the business for him.

CHAPTER XVII

THE CERTIFIED PUBLIC ACCOUNTANT AND THE INDUSTRIAL ENGINEER

Closely associated with the problem of negotiating commercial loans are some important factors, by-products, one might say, of credit analysis which, while not bearing directly upon the matter, are yet of significant influence in shaping banking credit. These by-products are concerned primarily with the clarifying work undertaken by certified public accountants and industrial engineers in assisting commercial borrowers to realize their maximum banking credit.

Importance of Audited Statements.—In an era of intense competition in business the commercial executive and banker have come to realize that no business enterprise can hope for prolonged prosperity that operates upon a haphazard system of accounting procedure. The realization is fast growing that business statesmanship lies in the art of coping successfully with the forces that paralyze industry, such as ignorance, friction, immobility, seasonality, and catastrophes. The means of controlling these forces lies in securing the facts about a business as it progresses. Through the accumulation and co-ordination of statistics concerning production, consumption and stocks, mutual confidence is created between the banker and his clients, with the appreciation that agreements are based upon established facts.

Today, therefore, credit officers of progressive banks insist that a borrower tender an audited statement. They encourage their customers who expect accommodations to know the mean-

ing of internal control; to learn how to budget their finances so that they will know accurately at all times their financial position.

There is consequently a serious need for close co-operation between the commercial borrower and the certified public accountant. Because of the importance of having expert assistance in presenting and compiling the statistical facts regarding business progress, there will be discussed here how the certified public accountant assists the borrower in obtaining commercial loans.

Services Rendered by Certified Public Accountants.—No matter in what condition a business may be, the certified public accountant can be of assistance. If the young borrower would commence operations by using his advice and services, open under his guidance a proper set of books, have periodical audits made, twice a year at least, or even monthly where the need is urgent, he would often find his relations much more satisfactory with his banker, who may be rather conservative when it comes to untried ventures, and will be encouraged by an honest effort to see the results of the enterprise properly tabulated and audited by a good accounting firm.

Too often the merchant-borrower calls in the accountant to his aid only after the chances for business success are lost. It is too late to get a great amount of real assistance from a certified public accountant when a business is on the verge of bankruptcy. The proper course to pursue in a given case can only be found by ascertaining the facts to be reckoned with, and these can only be obtained through the aid of men qualified to secure them and present them in such a way as to serve as a chart for the executives at the helm of the business.

Below is an outline of services that a well-qualified firm of certified public accountants may render clients borrowing from banks:

1. General audits to determine the financial condition and earnings of a business
    a. For the owner
    b. For credit purposes
2. Tax work
    a. Preparation of returns
        Federal income tax
        Federal capital stock tax
        State franchise tax
    b. Reviewing claims and preparation of briefs
    c. Representing clients before federal departments
3. Systems
    a. Installations
    b. Accounting
    c. Cost
4. Special investigations
    a. Purchase of a business
    b. Patent infringement
    c. Embezzlement or fraud by officers or employes
    d. Statements for "Blue Sky" commissions
    e. Bankruptcy and insolvency
    f. Partnership disputes
    g. Fire losses
5. Advisory and consulting capacity
    a. General financial advice
    b. Organization and reorganization
    c. System
    d. Re-financing
    e. Arbitrators in business disputes

It will be noted that the above outline is quite comprehensive, and that to render efficient service in all these ways requires specialists. For example, to be qualified to handle all federal income tax situations is no small undertaking. New rulings and cases are being decided every day, and it is quite a problem to keep abreast of all changes in the law.

Certified Public Accountant and the Prevention of Credit Frauds.—It has been estimated that a total of $160,000,000 is dishonestly taken each year by credit criminals. This load must eventually be borne by the ultimate consumer. The matter of credit frauds has become so important in the business world today that many national organizations have combined in an attempt to drive the credit "crooks" from the country. Heavy losses sustained through misplaced credit have so crippled firms and corporations that in numerous instances they have had to liquidate their businesses. Furthermore, from a banking angle, credit frauds have been known in many instances so to handicap an enterprise as to make it impossible for them to pay their bank indebtedness.

The first stage in credit fraud is the misrepresentation of facts and conditions. False financial statements are submitted as a basis for either a commercial loan or trade credit. A statement prepared by a disinterested outside party, who has verified all the facts in the statement, is usually looked upon with favor by the giver of credit. He feels, and rightly so, that to a certain extent this outside party has represented his interests, and he is in a better position to pass judgment on the credit to be granted.

The second stage in credit fraud is the fraudulent concealment of assets and bankruptcy proceedings. To avoid losses from such causes the progressive banker strongly urges his borrowers to take advantage of the aid of accountants, who, because of their experience in such matters, often during the course of their work find evidence which is of great aid in connection with the subsequent prosecution of the guilty parties.

Furthermore, the loaning banker feels more kindly disposed toward the concern which shows its good business judgment by presenting figures audited by an impartial firm of certified public accountants. In metropolitan centers, where the old time personal relationship is now impossible, it is not asking too much for bankers to request of their borrowers an impartial

presentation of their financial condition. The growing custom among bankers of requesting audited statements would indicate that it is absolutely essential for their protection.

Certified Public Accountant as Factor in Commercial Loan Negotiation.—From the point of view of negotiating commercial loans the certified public accountant is a valuable aid to the borrower. He is able to present an existing financial situation in such a way as to be readily appreciated by the banker. By reason of his experience in various lines of business he learns to so prepare and arrange statements that they will contain the various points of information essential to the adjudication of a credit risk. If a report is appended to the financial statement, it will contain sundry data and operating percentages which will serve to explain the various tendencies indicated by the financial statement itself.

The Balance Sheet Audit.—Perhaps 90% of the audits that are made at present are what are known as balance sheet audits, i.e., the verification of the assets and liabilities of the company at a given date. Usually in connection with this verification a sufficiently detailed check will be made of the routine transactions to satisfy the auditor that the books are being properly kept. An audit of this kind is generally satisfactory to the banker and is also of value to the client.

In undertaking to engage a public accountant to audit one's books the following points should always be definitely understood between the client and the auditor in order that responsibility will be definitely placed.

1. The fee. Public accountants usually work on a per diem fee basis
2. The kind of audit to be made
3. The period to be covered
4. The responsibility of the auditor in connection with the verification of: (a) accounts receivable, (b) accounts payable, (c) inventories.

The only verification that an accountant can really certify to is when the accounts receivable and payable have been verified by correspondence and the inventories have been taken at least under his supervision. Of all the items appearing on the balance sheet, the item of inventories is the most difficult of verification. The accountant's authority should not be limited in his verification of this asset, although unfortunately in most of the audits made today he has little, if anything, to do with the taking of inventories. His audit usually consists of a verification of the prices and the clerical accuracy. The tendency of the times seems to indicate, however, that public accountants are being made responsible for the physical verification of the inventory quantities. This is the ideal situation.

Many firms attempt to obtain and present financial statements to bankers which, on their face, show that they have been, not incorrectly, but improperly prepared. The salient points have not all been brought out in the statement, and as a result, the borrower is the loser. For instance, a systematic grouping of current assets and current liabilities, together with the relationship between the two figured on a percentage basis, may be a big aid in assisting the borrower in obtaining credit. A systematic presentation of operating data and information pertaining to the balance sheet items always makes a good impression on both borrower and banker. The public accountant's experience in other businesses of the same nature enables him to point out the strong and weak points in the financial structure of the company, so that the client may improve the weak points.

Occasionally the public accountant accompanies the borrower to the bank when arranging for credit. In such cases the public accountant is often in a better position than the client to explain the facts in his report to the banker, and may make a much better impression on the banker in this particular part of the process of obtaining credit.

The cost of the work performed by the public accountant is usually and properly borne by the candidate for credit. This is justifiable, not only because it helps to obtain the credit desired, but because of the other indirect results which are obtained in the way of improvement of the accounting or cost accounting system and advice in the preparation of federal income tax returns. Many business men have stated that the audit is worth its price alone for the moral effect it has on the employes.

Value of Verified Statements to the Borrower.—Some of the benefits to be derived through statements verified by the certified public accountant are discussed in the following paragraphs.

(1) Experience demonstrates that the audited statement does away with the objectionable tendency to color a statement. It is only human for the borrower to want to put his best foot forward. He is too apt to magnify his assets, and depreciate his liabilities. From a bank loaning standpoint the "show-front statement" is injurious to the applicant. It is not good policy, for example, for a concern to cramp itself financially, by pushing too vigorously its accounts receivable in order that it may show more cash in bank. It is a mistake to take any unusual measures simply for the purpose of putting a good front on the financial statement. A good audit presents the borrower's actual condition, not as he would like to have it. The facts often are that a reputable firm of accountants, in auditing a concern, may report the condition to be vastly different from that presented by the management. While the time when the audit is made is highly significant, the method of arriving at the figures may be different. The unbiased auditor naturally gets a different perspective in viewing the firm's assets from that of the management, who are anxious to make as good a showing as possible.

Thus it is that a verified statement is apt to prevent the

borrower from becoming over-optimistic about his condition. It keeps his feet safely on the ground, and without impeding his progress, makes for stability and conservatism.

(2) The audit tends to eliminate the temptation the borrower has to inflate his quick assets. For example, it frequently happens that a concern is desirous of showing for borrowing purposes a statement with a ratio of quick assets to quick liabilities of two to one. Under such circumstances it is natural for the applicant for credit to want to list as much under the heading of quick assets as possible. The writer has known of a case where a company had large stores of practically useless machinery parts and other doubtful merchandise of an unstaple character which were listed as quick assets in the inventory. Only after a visit to the plant was the fact disclosed that the inventory was inflated by at least $30,000.

Again, the case is cited of a company which listed a heavy inventory of copper wire. It made a good showing in the statement, but when the proprietor of the firm was asked whether or not it was staple, he was obliged to answer that much of it was obsolete for the purposes for which it was originally purchased. And the truth was disclosed that its sale value was much less than it was listed in the statement.

These are instances of "watered" or "loaded" quick assets. Yet from a banking angle, which is that of liquidity, they were of little value and left with the banker a feeling that the applicant for credit was over-optimistic in presenting his figures. The value of an independent audit, therefore, asserts itself mainly in checking the customer or prospect who is too confident and has a tendency to over-estimate. The banker encourages the borrower to use care in preparing his statement, realizing that in so doing it makes of him a more careful business man. It usually improves his buying methods, because a careful audit compels him to become familiar with his stock, and makes him more conservative in taking on new obligations. This often leads the borrower to the conclusion that he does

not need a loan after all, and the result is that he saves the interest he would otherwise pay.

(3) The audited statement aids the borrower in cleaning up his accounts receivable. Liabilities cannot be liquidated from fixed investments; they must be paid for out of the quick assets, the funds coming in from maturing accounts receivable. Some concerns are so situated that they are unable to get their accounts paid up promptly. Possibly they are not well enough established to be able to clean up old accounts. Thus often a company may be doing a good business, but has so much outstanding on the books as to be severely handicapped for working capital.

Certified public accountants are of great assistance to such concerns. They list all the accounts past-due separately, and take measures to get them paid up. Often they have prolonged the life of a shaky corporation for months as the result of vigorous measures applied to collections.

As a protection against bad accounts a growing interest is now being taken in the use of credit insurance. The concern pays an annual premium and in return is protected up to a specified sum on its accounts. This eliminates the possibility of heavy losses, and in some types of business is a judicious precaution to take.

Sometimes the banker will ask a borrowing concern to submit a list of accounts receivable when it is not very well established. Frequently such a step reveals that more than a third of the accounts are past-due. Naturally the banker draws his own conclusions.

All the above considerations are worthy of mention because of their significance to the borrower. He wants to meet his obligations promptly at the bank, but often is unable to because his business has gotten beyond his control. A complete audit often shows the borrower just where he is situated financially, and makes it possible for him to map out ahead just how to meet his obligations. Thus it is that many a business has been

saved from bankruptcy and all obligations cleared up, through the marshalling of the facts and figures by the skilled public accountant.

(4) In rare instances the certified public accountant aids the borrower to tide himself over a period of financial stringency through the pledge of his assets. Some financing concerns help business houses in weak financial condition by making advances to them secured by regular open book accounts. Conservative commercial bankers do not encourage this practice unless it is urgently necessary, because owing to the risk involved, the rate for the accommodation is much higher than the usual discount rates and proves so expensive as to make operating at a profit very difficult. When the accounts pledged are settled, the proceeds are applied to the money advanced. But in hypothecating its accounts, the company remains contingently liable for their ultimate payment.

When making an audit of concerns pledging their accounts receivable public accountants exhibit the receivables hypothecated separately from those which are not, so that the banker can see at a glance just how much money is expected in receivables to meet the obligations listed in the statement. Pledging accounts destroys the source to which the banker looks for ultimate payment of his own loans. Therefore, without the aid of an experienced auditor to set up accounts like this, a borrower often leaves a bad impression with a banker who, when looking over a statement not properly prepared, may become so confused as to conclude that the applicant for credit is short on business capacity and not a worthy risk.

(5) The public accountant understands how to list the borrower's notes receivable in such a way that they are quickly understandable on the part of the loaning banker. Often an inexperienced borrower will make the mistake of listing all his notes receivable under one heading when their varied character does not warrant doing so.

From a banking angle, in analyzing notes receivable it is

important to know whether the figures shown represent notes from customers only, obtained in the regular course of business or otherwise. If the borrower includes in this amount notes due from subsidiary or affiliated interests, or from officers or employes, the amount of such notes should be withdrawn and placed among the slow assets. The capable auditor understands the fine points surrounding such questions, and keeps the borrower from tendering his banker a statement so improperly drawn as to ruin his chances for accommodation.

(6) Another item of the statement on which the borrower often becomes confused and on which he receives valuable assistance from the certified public accountant, is that of notes payable. The banker scrutinizes the notes payable with much diligence. He wants to determine whether any or all of them are secured, either by endorsement or collateral, or in any other way. The audit is helpful in indicating to the banker and borrower whether the concern is in a healthy condition or not. There is no fixed rule regarding the proportion of debt the average concern should show as compared with its capital investment but, with rare exceptions, liabilities should be less than the total capital contributed by the owners. The owners should not ask creditors to put more in a business than they have themselves.

It is not unusual for a statement to show amounts in notes payable representing sums advanced by the officers and employes of the corporation. Sometimes the banker insists that a liability due an official be placed in note form and given to the bank to hold. This prevents the officer from getting his money to the detriment of other creditors, and at the same time gives the banker an advantage.

The banker always wants to know just what the character of the notes payable is, particularly when they are held by outside individuals. In not a few instances concerns have large amounts advanced by employes and others interested in the success of the companies which are short of working capital.

Conditions often indicate that the funds should actually be in the business through the issuance of capital stock, for even though the money has been loaned by friends, in the event of trouble, it is usually the first to be withdrawn.

Again excessive drawings may be made by officers who practically mulct the business. Large amounts are often due officials, having accumulated to such proportions as to hinder financial progress and cripple the business.

The audit made by a certified public accountant examines both for banker's and borrower's benefit, into the peak borrowings, and the period of the year when this figure is reached.

If the notes payable are excessive, it might indicate that the company should resort to new methods of financing, so that all the losses through failure to take discounts may be eliminated. Again, the audit may show the borrower that, because of high prices, it may be necessary for him to seek more working capital.

(7) There are a number of other special items appearing on the statement which frequently are not properly presented by the borrower unassisted. The public accountant helps him to clarify these in placing them where they belong so as to be readily understandable. In listing the items of real estate and buildings, for example, he sets forth clearly just what the concern has in them, setting forth the amount of the mortgage as compared to the total value. There are also such items as investments, bonded indebtedness, deferred assets, such as advances to salesmen and other advances, reserves, insurance on the lives of the principal executives, and others which the public accountant, by reason of his wide experience, is able to set up properly.

Frequently a bank prefers to send its own auditor to its customer's place of business. This is often done in spite of an audited report received from the borrower, as the bank might want to apply its own standards in investigations of credit risks, particularly at the inception of business relations.

Value of Verified Statements to the Banker.—Bankers know the risk of extending credit on the basis of unverified financial statements. Following are given a number of typical fraud cases where losses were due to lack of verified statements. They are taken from a bulletin published by the American Institute of Accountants entitled "Credit Frauds."

Example 1: John Doe, engaged in the tire business in Baltimore, with a branch in Washington, for more than two years, discounted his bills and anticipated every trade acceptance. On July 1st, 1920, he prepared a financial statement, which was not certified by an accountant, and which showed assets of $115,132 and liabilities of $32,500 and a net worth of $82,632. The principal items among his assets, as listed, were:

Merchandise	$46,580.00
Accounts receivable	19,485.00
Land and buildings	39,000.00

In November, 1920, he began to buy tires from many manufacturers in much larger quantities than ever before and in an amount exceeding $120,000. In January, 1921, he was not able to meet his maturing obligations and it was found that he had but a small amount of stock on hand in his stores. It developed that he had turned over to a commercial credit company tires to the value of $100,000 on which it had loaned $60,000 of which $50,000 was in cash and $10,000 was retained by the credit company to secure the payment of the $10,000 fee for the use of the money. Doe claimed that he lost the $50,000 in cash playing the races.

During the ensuing bankruptcy proceedings, the referee ordered the bankrupt to turn over to the trustee $50,000 in cash and $26,000 in merchandise for which he had failed to account. Failing to comply with this order, the bankrupt was committed to jail for contempt of court and served six months. Later he was indicted for using the mails to defraud by transmitting a false statement, pleaded guilty and was sentenced to serve a term of one year and one day in the Federal prison in Atlanta.

Example 2: A and B who were in partnership operating as the Blank Company, also as the X Company, and also as A. & B. Brothers, prepared a financial statement as of September 15, 1922, not certified to by an accountant, and sent it out to concerns from which they were buying goods and asking credit. This statement

showed a net worth of $35,000 and included among the assets merchandise to the extent of $12,300 and machinery and fixtures to the extent of $10,000.

On December 15, 1922, the company sent through the mails a financial statement to a mercantile agency of Boston, showing a net worth of $48,000. When the books of these bankrupts were audited by a certified public accountant employed by the trustee, it was discovered that on September 15, 1922, instead of a net worth as shown in the statement sent through the mails, there was a deficit of $7,200. Among the papers of the bankrupts was discovered a balance sheet, prepared by a public accountant employed by A and B that showed a deficit of $4,200. Notwithstanding this audit, they mailed financial statements to concerns from whom new purchases were made which did not agree with the audit.

Bankruptcy proceedings against this concern resulted in the preparation of a schedule of assets and liabilities, which on March 22, 1923, showed a total deficit of $35,622. The discrepancies between the books of the bankrupt and the statements they had made for the purpose of obtaining merchandise and lines of credit were made the basis of a prosecution on charges of using the mails to defraud and conspiracy to violate the bankruptcy act. The A and B brothers, including another brother who was an employe of the concern, pleaded guilty and were sentenced each to pay a fine of $200, a sentence which the creditors and those who had prosecuted the case regarded as very lenient.

Example 3: Juggling accounts to make them show a stronger current position for a business than the facts justify, is one method resorted to by commercial criminals who want to get more credit than would be given them if the true facts were known. This juggling can be done without changing the figures indicating the net worth.

A case is cited of a clothing manufacturer who personally prepared a statement showing his capital, as the sole proprietor of a business, to be $203,000. He later made an entry charging accounts receivable with $50,000, and charging accounts payable with $50,000, reducing his inventory by $100,000. He had a personal account in an out-of-town bank. He owed the business, according to his business books, $22,000 on December 30. On December 31, he deposited checks drawn on the out-of-town bank for that amount, clearing up his loan from the business. On January 2, he drew from the business checks totaling $32,000, and deposited them in his personal bank account. At the time he drew the checks on his personal account

he had but $1,000 credit there. In a sole proprietorship the drawing account is a legitimate charge against capital account, which should have been reduced by $22,000. An accountant, checking up a year's transactions, would reveal the nature and purpose of these transactions. He would find the changed status of current liabilities, and the inflated net worth. The ratio between current assets and current liabilities, which credit grantors study, was materially mis-stated in this case. When bankruptcy came, the creditors received about three cents on the dollar. Discharge from bankruptcy is being opposed in this case. Liabilities at the time of failure were estimated at $450,000 and assets at $100,000.

Auditor's Certificates.—Upon the completion of an audit wherein the balance sheet accounts have been verified and the net profits proved for the year, it is frequently required that the auditors prepare a certificate in which they certify to the correctness of the financial statements prepared by them. Of course, it is understood that the auditors cannot so certify unless they have had an opportunity to satisfy themselves as to the correctness of the two most important items on the balance sheet, the accounts receivable and the inventories. Otherwise they must qualify their certificate. If a certificate is desired in connection with the auditor's report, the client should have this understanding with the auditor at the time the engagement is made. Auditors' certificates are usually shown at the bottom of the balance sheet or on a separate page of the audit report.

Auditors' certificates are of two kinds, namely, the "short" form and the "long" or descriptive form. The "short" form is usually an unqualified statement to the effect that the auditor certifies that in his opinion the statement reflects the correct financial condition of the company at a certain date; while the "long" form of certificate is usually one which explains the scope of the examination and possibly makes a few qualifications. A banker should refuse to accept certificates which read, for example, as follows:

We have audited the books of the John Doe Company for the year 1925 and certify that the above statements are in agreement therewith.

A certificate of this kind is ambiguous and meaningless, as the books themselves may be wrong. Frequently a certificate of this nature will be found appended to a balance sheet, and it immediately indicates to the banker that the audit report is most likely one which cannot be depended upon or accepted in connection with the granting of credit.

Unfortunately there are still some business executives who object to presenting financial statements prepared by an impartial public accountant. They take offense at having their word doubted, as they view it. However, the old-time prejudice against audits and the presentation of statements certified to by certified public accountants is now rare among progressive business men. The preferential rates given on indemnity policies to concerns that have audits made periodically by public accountants and the employment of accountants in connection with federal income tax matters have done much to establish the services of the public accountant as a practical aid to sound business methods.

How the Industrial Engineer Aids the Borrower.—Another important aid in credit analysis is the work of the industrial engineer. Relatively few today are the commercial executives who appreciate the value of scientific business management and methods. Yet with the increasing competition and the growing movement toward large-scale production with low unit cost, there is a growing tendency to study more seriously problems of industrial management and business leadership. Because bankers have come to realize the importance to successful operation of sound and effective management, the industrial engineer has become a worthy counselor in establishing credit risks.

Scope of Industrial Engineer's Activity.—His activities may be roughly summarized in two fields:

1. Physical activities, pertaining to production as applied to machinery, plant, and the product, affecting borrowing power.
2. Human activities, relating to means for attaining greater efficiency in the organization, and thus insuring a better banking risk.

Of these two classes of activity it would be hard to say in which field the industrial engineer is the more useful to the borrower in securing credit, but for the moment attention will be devoted to the former. Every thoughtful banker in appraising a candidate for banking accommodations is vitally interested in all things affecting the product, and some of the questions which come up are: What will be the future demand for the borrower's commodity? What are the prevailing conditions relative to competition? How well is the product perfected, and will competition necessitate immediate changes in production and distribution?

All these questions and many similar ones the banker asks the borrower who must have the facts to be able to make an intelligent answer. But here difficulty arises. How is he to get the time to make the necessary investigation to develop these facts? And if the facts were obtained, how well coordinated would they be? Recent experience among bankers indicates that the industrial engineer offers constructive cooperation in answering these questions.

A well-balanced industrial engineering firm has experts in many lines of business. Thus there will be men who have had years of practical experience in the furniture business, the steel industry, railroad operation, and many other lines of business activity, so that when special investigations are required, the work may be undertaken by men having a detailed knowledge of the special problems which come up.

The great difficulty the banker finds in trying to analyze the borrower's financial position from the balance sheet lies in the fact that the conditions represented by the figures are not static. Circumstances influencing the fiscal condition of the company are constantly changing, and too often the banker is disappointed to find that the financial statement is most inadequate in the story it tells and that it, in truth, only pictures "water that has already flowed over the dam."

Determining the Future Demand.—What will be the future demand for the borrower's commodity? How will it affect his ability to pay his obligations? This the statement does not show; and to answer the question the banker and the borrower often find it advantageous, when circumstances appear to warrant it, to employ the services of an industrial engineer. Through their perspective gained through long years of experience in various industries, they are in a position, at least it is so claimed, to accumulate and analyze the facts with the thoroughness which can only be attained through specialization, and they are in a position, therefore, to rightly assist the bank in forming the background for judging its credit risks.

When banks are uncertain about the future of a particular concern they may suggest in special instances that the borrower seek the advice and experience of an industrial engineering concern. In such cases it would not seem unreasonable to expect the company seeking credit to pay for the cost of gathering the necessary data for the banker, for whether or not the bank chooses to grant the credit, the benefits of such an investigation accruing to the prospective borrower's business will frequently more than compensate him for the outlay.

Judging Competition.—Questions relating to competition often come up which require a thorough investigation. How well is the company located from a production angle as related to transportation? In an analysis made by the author of 50

companies rejected by the discount committees of banks throughout the country, there were 7 companies, or almost 10%, which were rejected because of unfavorable location and business conditions affecting it. The table of rejections on page 138 indicates the seriousness of these considerations relating to banking credit. In this analysis there were factors surrounding the credit risks that could only have been solved by a comprehensive research by an accredited firm of skilled industrial engineers.

Determining How Well the Product Is Perfected.—Other questions of much import bear directly upon how well the product is perfected, and whether competition will necessitate immediate changes in production and distribution. Only a wide survey of the special field of activity and the problem of production and distribution will clear up questions as perplexing as these. And if the engineer is unable to forecast the future for the business executive and his banker, the material gathered is nevertheless helpful, making for economical production and intelligent expansion.

Rejuvenating Old Companies to Make Better Credit Risks.—Again, there are many cases involving enormous credit commitments which prove perplexing to the banker. In some instances the bank finds that a concern which for many years has been regarded as a good risk has shown such diminishing earnings that the bank finds itself in the position of having to require an investigation before further accommodations are accorded. Sometimes, the engineering firm employed will find that in the course of time the company has become antiquated in its production methods. Again, its equipment may be found inadequate to keep pace with the demands of production; and lastly, there may be "dead wood" in the organization which must be cut out before satisfactory earnings can be realized.

In the following analysis,[1] compiled by a successful industrial engineering firm, there are listed a number of things which, it is maintained, an organization may effect through co-operation with industrial engineering specialists.

I Better leadership
More teamwork among departments
Keener interest in self-development

II Better placing of workers
Improved relations with labor
More effective incentives
Less "bossing"—better discipline
Better instruction of workers

III Better organization of work
Reduced labor turnover
Less friction
More company spirit

IV Better layout and routing
Better care of equipment
More economy in materials
More economy in supplies
Cutting down repairs
Improvements in equipment
Improvements in processes

V Better records of production
Closer check on workers' time
Stopping leakages
Cutting down idle machine time
Closer adherence to schedules
Controlling costs

VI Better analysis of problems
Better systems
Better morale and goodwill
Better co-operation with the management

[1] William H. Lough, of the Business Training Corporation, Forty Thousand Better Foremen.

It will suffice to refer to Group IV which outlines some of the benefits to plant and equipment, and their relation to production. Obviously, the borrower is in a better position to ask for credit if the maximum of production with the minimum cost is realized. But often it is asserted, it takes the outsider's viewpoint in some instances to show the executive and plant operatives how to make the most of their opportunities.

Assisting in Mergers.—Frequently banks are called upon to pass upon a line of credit in the case of a merger of several concerns. If the loan is judiciously made, there may be ample security for the bank and the stockholders. To do such a situation justice, the banker is often compelled to go outside his banking staff to gain a satisfactory and unbiased opinion and analysis of the undertaking and to accumulate all the data required.

A sounder basis of judgment will thereby be afforded, when the borrower presents a report that goes into the production end of the business. And on this particular phase of credit the banker is often handicapped, because with the increasing complexity of modern production, he finds himself in need more than ever of scientific analysis—the result of specialized investigation expertly undertaken. The industrial engineer supplies this need and makes for increased confidence and more satisfactory relationships between the banker and his clients.

The Human Element and Commercial Loans.—Most important is the human element in business. In large-scale operation, where business becomes highly specialized, and many workers are employed, the success of an enterprise and its position as a credit risk depends much upon good management and the efficiency of the organization. No one thought a few years back of providing a special training course for employes. They were supposed to get their training solely through practical experience. Industrial practices have made striking progress,

however, within recent years. Methods of handling equipment and materials have been studied and improved. Records are more accurate and are more thoroughly analyzed. Scientific methods in all activities are more generally used. Relations with labor are cultivated more carefully. All these factors make indirectly for happier borrowing relations, and stronger security for the lending bank.

The higher officers of progressive plants keep in touch almost unconsciously with such changes. They are continually interchanging ideas with other executives and with their banker, watching those ideas work out in other plants, hearing them presented at conventions, reading about them in industrial books and journals.

The difficulty lies in imparting initiative to the rank and file, of developing leadership in the pivot men, the group leaders who are in daily close contact with the men in the organization. Executives often find that mere group meetings will not accomplish this. And bankers sometimes find that the leadership and morale of the department heads, foremen, and others of a company's employes are so ineffective that the concern must be regarded as a poor risk.

The solution lies, it is asserted, in encouraging the members of such an organization to greater and more intelligent effort through training courses. In this way executives, in cooperation with industrial engineers, succeed in firing their workers with ambition and developing a keen interest in their daily tasks.

The era of scientific business control has arrived. Because of their broadening outlook upon commercial affairs the bankers see in this new era more stability in operation, more consistent progress, and safer credit commitments for the borrower and his bank.

CHAPTER XVIII

COMMERCIAL PAPER

Commercial Paper Defined.—Of all the forms of unsecured borrowing which have developed during the past 25 years, none has grown more into prominence through the utilization of productive resources than commercial paper. Ordinarily the term commercial paper among bankers means notes of merchants and manufacturers which are payable generally in 3, 4, or 6 months, and are issued in denominations of from $2,500 to as high as $100,000. These notes the banks buy as a form of short-term liquid investment through commercial paper houses which make a specialty of this type of banking.

For the merchant-borrower commercial paper is an advantageous medium for keeping his bank lines open for use in times of emergency. It is erroneously thought by some that commercial paper is intended as a means of relieving commercial concerns who have reached their loaning limit with their commercial banking connections, but such is not the case. This form of borrowing is not intended to encourage over-expansion of credit. It is represented for the larger part by notes which in their amount are often covered by open lines of credit with commercial banks, making it possible for them to be liquidated immediately through loans made over the counter upon maturity. The use of commercial paper, therefore, is a system of borrowing which is collateral to that of regular commercial loans and is not intended to replace, or to be substituted for, regular bank loans. It is true that where banks dealing with merchants find they are legally restricted, and where their resources are not sufficient to take care of their depositors, commercial paper houses are able to render the necessary assistance.

They provide credit through a wide distribution of notes bought outright from merchants and are, therefore, an important factor with commercial banks in financing business.

Position of the Commercial Paper House.—For every commercial borrower contemplating making a connection with the commercial paper broker, it is, broadly speaking, of the most vital importance to appreciate just what information is required, and how best to be prepared to present this information. It is with this thought in mind that there will be outlined here briefly some of the more essential points the commercial paper broker considers before buying commercial paper. Because the commercial paper broker is continuously marketing loans of extremely large proportions and because such loans do not constitute merely one loan, but rather a series, and actually involve the establishment of a banking connection which carries with it an implied agreement that for an indefinite time a more or less constant series of commercial paper loans will be made, an exhaustive investigation is deemed absolutely essential. The high moral responsibility to banker clients, the maintenance of prestige, the preservation of good repute, and the lending of such gigantic sums of money that, in times of depression, heavy financial losses are bound to result—all this makes the commercial paper broker very chary in making commitments and conservative in his appraisements.

Commercial Paper House Credit Departments.—From the foregoing it can be readily understood how the systematic organized credit investigation in large commercial paper houses has of necessity kept pace with the developments in commercial banks, as has been suggested in previous chapters. Like the regular commercial bank, the commercial paper house desires enduring connections. It makes its investigations and solidifies its relationships for an indefinitely long future, as there must be the assurance that the prospective client will continue to

prosper and flourish. Consequently, the most comprehensive investigation is undertaken. When the commercial paper house is seeking or is offered a connection, the question to which it must address itself is not whether the immediate borrowings are certain of repayment, but rather whether the notes of the particular company or institution under consideration will continue to be a good paper over a long period of time.

Making Use of the Agencies.—When about to go into such an investigation a commercial brokerage house may avail itself of an agency report on the subject. These agencies prepare special information for the use of commercial paper houses concerning those merchants desiring to sell commercial paper. The agencies are well-organized and well-conducted bodies, and while they supply much useful information, the bankers take into consideration the excessive caution with which they view the subjects they report. Experience shows that the nature of the agencies' business tends to place a premium on excessive caution, since they are risking reputation only and never money, and it is but natural that they should confine themselves to the formal analysis of statements and checkings with a view to outlining present conditions. What they try to show is whether or not the subject has sufficient liquid resources to insure the payment of present commercial paper obligations. But with the commercial paper house it is rather a question of judging the risk with a view to the long pull, knowing that the real function of the commercial paper house is to syndicate loans, which, for one of several possible reasons, it is impracticable for the local banks immediately associated with the borrower to carry alone; and knowing that the names accepted may be of such a high character as to be readily accepted in turn by banks all over the country.

Other Credit Bodies.—There are other credit associations or other credit sources available, the National Credit Office

being of much assistance. They send out a list of queries to the banks concerning well known commercial paper houses, asking whether accepted or refused, and, if refused, ask the reasons why. The answers to the questions are compiled into very useful reports, which are sent to the banks which are members of the association or write in for information.

How the Banker Judges the Open Market Borrower.— From the foregoing it can readily be seen that the commercial paper house is obliged to equip itself with industrial experts, economists, and statisticians, as well as with the usual machinery of credit investigation, if justice is to be done the open market borrower. This is especially true when one considers that to be a satisfactory open market risk the borrower should meet certain requirements which only detailed analysis will disclose. And experience shows that the business of the open market borrower should essentially be one in which there is a rapid turnover, with requirements for current operations which rise seasonally or frequently to a point beyond the limits within which the local banking connections are sufficient. Given such a business, what must the banker know before he commits himself, what also must the borrower furnish in the way of information? For the sake of conciseness this discussion will be divided into 3 main topics, as follows:

1. Information required about present conditions and the probable future of the industry or business in which the prospect is engaged, providing an economic survey of the situation.
2. Information that must be secured which will make it possible for the lending organization to determine the position or place of the prospect in the industry in which he is engaged.
3. The financial analysis and credit examination that must be made by the lender to have a clear picture of the

prospect's financial structure and information concerning his credit standing with his banks and suppliers.

Under the first heading some of the questions the commercial paper investigator wants an answer to may be well worth mentioning here. Is the industry over-developed or is it facing a period of expansion? Is consolidation or cut-throat competition and demoralization a possibility? Or can the borrower reasonably foresee a steady growth in the demand for his product, and can that growth be estimated? Is it possible that some other rising industry may supplant it? How is the industry affected by tariff, and will it suffer from foreign competition, or will it enjoy a foreign market? What about its sources of raw material, and are changes possible in its raw material market which may affect or extinguish its margin of profit? These are a few of the questions which come up when analyzing the business outlook, and which the open market borrower is as anxious to have answered as the commercial paper lender.

Determining the Open Market Borrower's Position.—One of the most important considerations, and one which embraces a number of points, is that relative to the matter of determining the commercial borrower's position or place in the industry. The question arises, if there is to be cut-throat competition, is the prospective commercial paper borrower going to be in a strong position? Will he get a fair share of the increased demand, or will more favorably placed units enjoy satisfactory growth while they remain stationary? In sum, is the prospect in the position economists term "marginal"—that is, does he make money only when conditions are exceptionally favorable, and shut down or blow up, when times are bad, or is his position such that even under severe conditions he can still do business at a profit, or at least without loss? In order to challenge this line of inquiry, it is worth while here to consider some of the questions which are a part of our main inquiry.

The question of location, for example—what bearing has that on establishing the open market borrower's position in the industry? It is generally agreed that location, *per se,* is not necessarily a reason or cause for the rejection of a loan application on commercial paper. Yet location with reference to freight rates; location with reference to the principal markets and the principal sources of raw materials; location with reference to power, coal and labor supply—these are factors which no thinking credit man or conscientious lending banker can afford to overlook, even though willing to admit that there is something in Emerson's remark about the world being willing to wear a beaten path to the door of the man who makes a better rat-trap than his neighbor.

The table given on page 390 shows a tabulation of fifty companies whose commercial paper offerings were rejected by the discount committees of banks throughout the country. It is of interest to note that a significant cause for rejection in seven cases was concerned with the location of the plant. It is not intended here to leave the impression that these companies were refused accommodations merely because of their geographical location. Where one company might, because of the circumstances of its management, operation, and backing, make a big success in a particular location, another company might fail in the same location. These rejections were made only with reference to the particular business as affected especially by its location when considered in the light of all other information concerning the risk.

Property and Equipment.—There are also the questions which have to do with property and equipment. Reference is made here to what has been previously brought out regarding the work done by appraisal companies in assisting borrowers and bankers in establishing their position in regard to equipment valuations. If the commercial paper house is concerned with a merchandising business, it wants to know something

about its place of business, its stores and warehouses; and these questions are of very much more importance in the case of a manufacturing business. Full information about plant capacity and the general character, condition, and layout of structures, machines, and equipment, all have a direct bearing on the risk, and are weighed in with the final considerations.

Organization and the Commercial Paper Risk.—Yet another branch of the inquiry made, and one which certainly is equal in importance to the others, is that concerned with the organization. Here the commercial paper credit man wants to know a great deal about the general scheme of organization and about personnel, and by personnel is not meant merely the directors and executive committees and presidents alone, but includes the sales managers, merchandise men, engineers, superintendents, works managers, production managers and others whose efforts will be reflected in the company's progress. The commercial paper credit man is desirous of knowing whether or not there is a capable well-knit organization with a satisfactory amount of that extremely important intangible asset which meant so much in the World War and which means so much to successful business always—"esprit de corps."

Making the Financial Analysis and Credit Examination.—The third important step in passing on a commercial paper name involves the financial analysis and credit examination. Much has been previously said regarding the measures taken by the commercial loaning officer to protect commercial obligations. The conservative commercial paper broker is equally cautious, perhaps more detailed in his analysis than the commercial banker, because of the extent and duration of his arrangements with his customers. They need to have a clear picture of the prospect's financial structure; need full information about its present credit standing with its banks and those firms which supply it.

COMMERCIAL PAPER ANALYSIS

Fifty offerings of concerns rejected by the discount committees of banks throughout the country

NUMBER OF REFUSALS	REASON FOR REJECTION
15	Statement not satisfactory.
11	Company too small, and other miscellaneous causes.
9	Unfavorable checkings.
7	Unfavorable location, and other business factors.
2	Low cash balances.
2	Not enough banking connections.
1	Company showed lack of progress.
1	Commercial paper in excess of bank lines.
1	Involved with other companies, status not determined.
1	Rate of interest too low.

The basis for the above analysis was taken from 50 rejections of commercial paper offerings by banks throughout the country chosen from the credit files of rejections with a view to throwing some light on the things bankers think about when passing upon commercial paper offerings. It should be borne in mind that in many instances the question of rejection is largely a matter of judgment, and that bankers might differ in their opinion regarding the risks. The principal reasons for rejection, as shown in the files, are here set forth for the reader's consideration, but in contemplating the analysis it is important to make allowance for the background and training of the bankers, and their particular viewpoint, which, of course, differs with different bankers according to their experience.

Because much of the ground relating to investigating the risk has been covered in previous sections, it will be more advantageous here merely to note briefly some of the salient features in commercial paper analysis, with a view to throwing some light on the thoroughness with which investigation work is undertaken. Comprehensive detail, for example, is collected pertaining to the present condition and requirements of the risk. What, for instance, is the quality of the credit the risk now enjoys, and if it is in discredit in any degree, is that discredit serious and how did it occur?

As in the making of commercial loans by banks to clients, a commercial paper house may work out complete balance sheets, profit and loss statements, and economic and engineering data as a basis for an independent estimate or forecast of credit requirements. The investigators may go so far as to prepare independently from their own data, which have been derived

from internal investigation of a specific business, a budget of income and expenses, receipts and disbursements, by which it may be enabled to check the reasonableness of the borrower's offerings of paper, and thereby avoid the risk of having paper loans go into bricks and mortar. The value of such a constructive procedure has already been touched upon in a previous chapter and so no further comment will be necessary here.

Essential Points in the Practical Financial Analysis.—With a view to throwing some light on commercial paper analysis from a practical standpoint, for the banker or merchant buying or selling commercial paper, the author has analyzed 50 commercial paper offerings rejected by the discount committees of banks throughout the country. The results of this analysis are shown in the table on page 390, and some of the statements selected are to be found in the next chapter. The companies were selected to give a cross-section of typical commercial paper offerings, which it is hoped will be helpful in bringing out some of the points emphasized in the previous pages.

What One Analysis Showed.—Investigation revealed that of the 50 concerns considered and refused accommodations, 44% of them were scattered territorily throughout the country, and with an equal diversity as to character of business. The wide range of business activity and the great geographical distribution was due to the desire to minimize the effect of local depressions which might affect unfavorably the business interests of a particular section of the country.

Industrial Classification of Paper Names.—In making their selections from many different classes of business the discount committees minimized the possibility of financial embarrassment or failure of their loans by reason of any changes of styles, or a backward season as affecting a particular industry, thereby making impossible the prompt payment of obligations.

By way of illustrating the industrial distribution of open market borrowers throughout the country, attention is called to the following table, which gives a classification of the concerns that borrowed in the open market in 1923, according to basic lines of industry:[1]

852	Textiles 33.0%	57	Paper 1.8%
481	Foodstuffs 18.5	31	Tobacco 1.2
442	Metals 17.0	18	Building 7
208	Leather 8.0	10	Rubber 4
177	Lumber 6.8	8	Automotive 3
122	Chemicals 4.7	198	Miscellaneous 7.6

It will be noted from the foregoing table that a satisfactory distribution of commercial paper holdings is readily realizable on the part of the selecting banker or purchaser.

Bearing upon this point it is to be observed that 7 out of 50 rejected offerings were made by the committee because local market conditions, due to an unfavorable location, as affecting a particular industry, were not considered favorable, or for closely allied causes which tended to retard the concern's progress. One rejection was due to "Heavy increased inventory with prices at the peak, with the possibility of a drop." Comment on another rejection was: "Exception was taken to a portion of a concern's business which was regarded as undesirable in its nature." The current ratio was five to one. Again, another firm "appeared to be engaged in too many lines of business." Still another company "was operating in a locality which was regarded as not suitable to its progress," the inference being that some other concern might make a satisfactory showing in the same locality.

Of these 7 offerings only one concern showed a ratio of current assets to liabilities of less than two for one, which indicates that business conditions and geographical and industrial considerations played a significant part in the selections made for the bank's portfolio.

[1] History of Commercial Paper, 1920-24, by National Credit Office, N. Y.

Geographical Division of Paper Names.—As a means of emphasizing more clearly the possibilities in making a comprehensive geographical division of paper names there is exhibited below a table compiled to show the percentage and number of open market borrowers in each of the Federal Reserve Districts: [2]

Federal Reserve	Percentage	Number
District No. 1	11.8	307
" " 2	17.2	448
" " 3	5.3	137
" " 4	4.8	125
" " 5	6.5	169
" " 6	7.8	203
" " 7	20.1	522
" " 8	5.5	143
" " 9	2.7	70
" " 10	7.1	185
" " 11	5.8	151
" " 12	5.4	140

A glance at the above table gives the reader an appreciation of the wide distribution geographically of open market borrowers. It is of interest to note that the first borrowings of this nature were confined to dry goods commission concerns in New York City, because sufficient accommodations from depositories could not be obtained; also that today open market borrowing is used by every stable line of industry in every section of the country. New York has lately been superseded by Chicago as the district in which the largest number of concerns selling their notes through commercial paper brokers are situated.

Rejecting Commercial Paper Offerings of Small Companies.—Coming back to the analysis in the previous discussion, and referring the reader to the analysis on page 390, it is observed that 11 of the 50 rejections were made because the companies offering the paper were thought to be too small.

An authority on commercial paper once suggested that "No concern with total assets of less than a quarter of a million dollars should be considered." This was doubtless maintained

[2] History of Commercial paper, 1920-24, by National Credit Office, N. Y.

because it was thought that the management and continuity of business policies were more apt to be stable and advantageously adhered to by larger enterprises. The following table shows a division of names according to the size of the commercial paper borrowers throughout the country. This has a direct bearing on the topic under discussion, showing the amount of money invested in the different businesses on the percentage basis:[3]

Below $250,000	4.5%
$ 250,000 to 500,000	18.9
500,000 to 1,000,000	25.4
1,000,000 to 2,500,000	26.7
2,500,000 to 5,000,000	11.4
5,000,000 to 25,000,000	10.5
Above 25,000,000	2.6

These names, it will be noted, are almost evenly divided as between traders and manufacturers; 48% are traders and 52% are manufacturers. It is interesting to note that only 4.5% of the companies had a capital investment in the business of less than $250,000, which seems to bear out the limitation put on size as affecting the chances of a commercial paper offering.

When considering the rejection of 11 offerings referred to in the analysis of the 50 companies in the table on page 390, it is to be observed further that the discount committees' opinion of what constituted a "small concern" was based with emphasis primarily on working capital assets rather than on total assets or capital as a basis for selection. In fact, the committees voted refusals on these 11 concerns with average total assets of well over $500,000, and with an average capital stock of over $755,636. Yet the fact that the average cash balance for each company was not as high as might be expected, and the fact that they showed in a number of instances a decrease in current assets over previous years, substantiated the judgment of the committees that working capital and cash resources were limited. Consideration was also given to the fact that the concerns

[3] History of Commercial Paper, 1920-24, National Credit Office, p. 3.

were not very well-known, and were in some cases also not thought to have sufficient banking connections.

Change of Financial Ratios From Year to Year.—In selecting commercial paper offerings the banker aims to choose companies showing naturally a strong working capital position. This would not mean that because a statement, for example, showed current assets of less than two for one, the company was in a dangerous position, but that from a wide range of offerings it is obviously advantageous to secure the broadest margin of safety possible.

In the table shown in Figure 51, compiled by the Bank Service Department of the National Credit Office, the important ratios for the principal divisions of industries are given. These ratios which, it will be noted, are for the most part considerably in excess of two for one, are based upon the financial statements of every concern in the divisions listed, which sold notes in the open market during 1925. The ratios are simple arithmetical averages, and do not represent modes.[4]

It will be observed that the number of concerns used in determining the averaged ratios ranges from a minimum of 20 woolen cloth mills to 216 wholesale grocers. The number in each group is sufficiently large to make the results representative of open market borrowers.

In studying these ratios it should be kept in mind that they are not standards, they are not normals but are averaged ratios based upon the financial condition of a cross section of the thin uppermost strata of business enterprises representing the better risks in our commercial and industrial life. These concerns are in every section of the country and have an average net worth of about $1,250,000.

With this understanding the ratios may be studied as a basis for judicious comparison. In general, they represent the "desired" showing, the "hoped for" showing rather than the "re-

[4] The mode is the predominating rate, size or quantity in a group or series.

Lines of Industry	Number of Concerns	Quick Assets to Quick Debt	Profits on Sales	Profits on Net Worth	Turnover of Working Capital	Turnover of Net Worth	Collection Period	Turnover of Inventory	Net Worth Represented by Fixed Assets	Net Worth Represented by Quick Debt	Net Worth Represented by Total Debt	Working Capital Represented by Funded Debt	Working Capital Represented by Inventory	Inventory Represented by Quick Debt
TEXTILES		Ratio	%	%	*	*	Days	*	%	%	%	%	%	%
1. Converters Cotton Goods	27	2.66	3.00	5.30	3.20	2.80	66	3.10	17.0	54.0	55.0	—	87.0	68.0
2. Department Stores	115	4.07	3.06	9.80	3.66	3.20	48	5.08	48.6	25.2	29.3	44.2	75.0	66.4
3. Factors	20	1.94	1.06	6.48	8.55	7.06	56	—	—	131.0	131.0	—	—	—
4. Mfrs. Men's Wear (Cutters)	55	4.07	5.19	10.38	2.61	1.99	84	4.17	13.9	30.5	32.0	—	60.0	71.4
5. Mfrs. Hosiery	21	3.62	3.62	6.39	3.09	1.59	46	3.54	39.5	24.8	71.2	—	96.9	50.0
Mills														
New England														
6. Cotton Cloth Mills	46	2.53	†7.05	†7.04	5.72	1.13	58	2.69	72.0	40.0	43.0	—	161.0	47.0
Southern														
7. Cotton Cloth Mills	77	1.85	2.40	2.00	4.10	1.00	25	2.50	67.0	30.0	32.0	64.0	143.0	79.0
8. Cotton Yarn Mills	29	3.64	3.90	4.10	5.10	1.30	42	5.10	67.0	14.0	15.0	—	75.0	41.0
9. Mfrs. Knit Goods	21	3.77	4.00	5.50	3.00	1.50	49	3.90	41.0	19.0	21.0	—	77.0	46.0
10. Wholesale Dry Goods	96	2.89	1.90	3.50	2.40	1.90	115	3.40	17.0	42.0	46.0	—	69.0	76.0
11. Wool Dealers	22	4.77	3.91	19.58	7.15	6.58	40	7.66	6.9	73.0	73.0	—	97.0	78.0
12. Woolen Cloth Mills	20	4.14	5.27	6.45	2.89	1.52	59	3.12	48.0	29.0	31.0	—	106.0	51.0
FOODSTUFFS														
13. Flour Millers	56	3.35	3.10	12.10	8.90	3.80	18	11.77	52.0	18.0	31.0	30.0	72.0	59.0
14. Meat Packers (Big 4 eliminated)	29	3.29	2.60	12.20	9.70	4.70	15	12.16	62.0	21.0	38.0	35.0	73.0	60.0
15. Wholesale Grocers	216	2.58	2.10	8.50	5.40	4.00	46	5.61	20.0	47.0	48.0	—	88.0	72.0
METALS														
16. Mfrs. Light & Heavy Machines	89	3.76	8.00	11.00	2.70	1.40	62	3.50	47.0	17.0	22.0	—	73.0	49.0
17. Mfrs. Stoves & Ranges	23	4.08	9.00	14.00	2.50	1.40	115	4.80	34.0	18.0	21.0	—	51.0	63.0
18. Wholesale Heavy Hardware	79	2.93	4.00	6.00	2.30	1.50	109	2.80	20.0	35.0	37.0	—	80.0	65.0
19. Wholesale Light Hardware	93	3.14	3.00	8.00	3.30	2.30	77	3.70	16.0	35.0	37.0	—	79.0	58.0
LEATHER														
20. Mfrs. Shoes	46	4.52	3.10	7.51	3.44	2.13	77	5.17	38.0	36.0	36.0	—	72.0	70.0
21. Tanners Upper Leather	20	2.91	4.80	10.50	3.54	2.13	41	3.57	40.0	37.0	37.0	—	105.0	56.0
LUMBER														
22. Mfrs. Furniture	42	3.94	6.00	10.00	2.64	1.31	88	4.18	43.0	22.0	24.0	—	65.0	62.0
23. Mfrs. Lumber	25	1.87	4.00	3.00	4.24	.95	77	4.30	91.0	20.0	41.0	—	122.0	77.0
24. Retail Furniture	22	3.66	8.00	13.00	1.45	1.55	323	5.08	18.0	40.0	50.0	—	30.0	130.0
25. Retail Lumber	54	5.20	6.00	10.00	2.79	1.66	101	2.08	45.0	19.0	22.0	—	92.0	37.0
26. Wholesale Lumber	36	2.93	4.00	7.00	2.27	1.76	175	5.27	48.0	16.0	22.0	20.0	67.0	73.0
MISCELLANEOUS														
27. Auto Finance—Retail	26	1.59	3.96	14.42	5.21	5.16	–	—	—	244.0	244.0	—	—	—
28. Auto Finance—Wholesale	21	1.48	2.16	14.12	7.67	7.21	–	—	—	237.0	237.0	—	—	—
29. Wholesale Drugs	47	2.75	3.00	7.00	3.88	2.52	67	4.50	19.0	36.0	37.0	—	79.0	69.0

*Number of times †Loss

Figure 51. Important Ratios for 1925 in the Prominent Industries Using the Open Market

quired" showing, which a company must make to be considered a sound credit risk. The reverse statement of fact, however, that financial statements which reveal better proportions than the ratios set forth are superior credit risks, will invariably be true.

Ratios Change with Conditions.—Ratios, determined by averages or modes, naturally fluctuate from year to year depending upon the trading or economic conditions prevailing in particular industries.

For example, if farmers have a poor year, the sales and profits of farm implement manufacturers fall off that year and maybe the following year, so that ratios based upon these units, either as a numerator or denominator, depart from the previous base.

If the reader will examine the table of ratios on page 396 he will note the outstanding changes which reflect the result of operation for the preceding 12 months, compared with those of the year previous, indicating the following:

1. Smaller sales and profits in several divisions of the textile industry.
2. A marked expansion in the collection period of wholesalers of dry goods.
3. More profitable operations in the leather and several of the metal lines.[5]

By means of such an analysis the banker is kept abreast of movements and conditions existing in the various industries. He is able to act with enlightened discrimination, and avoid the possibility to some extent of selecting offerings of companies which, when considered in the light of all the facts, do not seem to have a propitious future.

Commercial Paper Statement Analysis.—Again, referring to the table on page 390, it is interesting to note that 15 rejec-

[5] Bank Service Department, National Credit Office, N. Y. Report, January, 1926.

tions out of 50 were made because the statements were not regarded as satisfactory. Thus, 3/10 showed some radical weakness in the balance sheet position. Of these 15 concerns 7, or nearly ½, showed a current ratio of assets to liabilities of less than two for one, or a declining ratio over a comparative period of several years.

Assuming that the discount committees had eliminated the 7 offerings with weak current ratios, what about the 8 companies remaining? An analysis of these revealed that excessive inventories eliminated 2 offerings, and the remainder of them were rejected for secondary causes. "An increase in notes receivable whose value was uncertain" eliminated one offering. "Large accounts receivable in the form of advances" was an objection against another. Again, a committee took exception to too high an inventory of one particular item in the case of another. And, finally, a rejection was made because the statement submitted was too old to provide a sound basis for consideration. A new statement and an audited one is the only safe procedure.

It can be inferred from the elimination of the offerings set forth in this analysis that adequate working capital requirements play an important part in a corporation's bid for public and banking favor in the sale of their paper. And the banker is constantly on the alert to safeguard his assets by choosing only such paper as is backed by a corporation in a strong cash position with a generous margin of safety.

In buying commercial paper it is contended that no item in the statement is negligible, and that each deserves full explanation in the event that the content thereof is not obvious. For instance, a commercial paper buyer, in recently analyzing the statement of a prominent open market borrower found a large item appearing in the assets under the heading of notes receivable indicated in round numbers. Upon investigating it was found that these receivables were due for commercial paper

which the company expected to sell through the note broker handling their paper on a consignment basis.

In analyzing a statement, no investment is too small to call for a full explanation. It is vital, for example, whether or not an item represents the total or majority of the outstanding capital stock of another company. Naturally, the subject under review is proportionately liable for the debts of its affiliated organization to the extent of the stock it controls and, consequently, where occasion arises, a statement of the affiliated or subsidiary company should be furnished in order to give a clear picture of the enterprise being investigated.

Beginning with the year 1925, many commercial enterprises which had previously reflected in their financial exhibit a mortgage encumbrance on fixed properties, decided that statements when published would appeal to prospective stock purchasers and commercial paper buyers in a far more attractive light if no mortgage obligation was in evidence, and consequently in many instances a realty company was formed taking the title of John Doe & Company, Real Estate, and John Doe & Company would in turn show its investment in the realty company as "stocks" and "bonds" or some other meaningless financial phrase.

In the case of a concern operating a realty company, and where the latter has placed a mortgage against company properties, a trust indenture should be procured, inasmuch as it is important that the terms of the trust deed be understood; because only through this can the full facts be secured with regard to the contingent liability of the corporation as guarantor of the quick assets position as supporting a time loan. A prominent firm of attorneys recently decided, after a thorough research, that there was no possibility of a mortgage being a lien against the quick assets of a company, but they forgot to mention that if the loan is made against industrial property by the corporation itself, there is always the danger of a defi-

ciency bill being filed against the current assets in the event of default, foreclosure, or the sale of the mortgaged property.

Space will not permit further elaboration upon the technicalities involved and only rarely gone into by the average bank credit man in his analysis of commercial paper names, but it may be of interest to comment here upon the significance of debt in the analysis. Concerning the debt fluctuation, it will be readily admitted that when trouble arises it invariably begins for the borrower when the company's peak indebtedness has been approached. It will very often be the case that liabilities at the company's peak indebtedness will exceed net worth, this being the case in certain lines of business that are considered seasonal. It is here, however, that the question of capable management demonstrated over a period of years must be considered, and comparative statements issued from year to year bring out whether or not conservative borrowing methods have been pursued.

Importance of Good Checkings.—One of the most important criteria of commercial paper is that relating to bank and trade checkings. Reverting to the table on page 390, it is perceived that 9 offerings out of 50 were refused because of unsatisfactory checkings. Thus nearly one-fifth of the concerns were shown, in spite of the fact that all of them revealed a ratio of better than two to one, to have some inherent financial weakness which it took checkings to clear up.

When a bank investigates a name for the purpose of commercial paper one of the primary requisites in making the decision is that of securing adequate bank checkings. Without good banking checkings no name will be acceptable.

Briefly noted in the investigation of 50 concerns (see table on page 390) the bank checkings showed by analysis in two cases that the progress of the concerns was not as healthy as it should be. Two other firms were found to have weak man-

agement and to have lost considerable money during the last 2 years. Still another showed large receivables due from companies going through receivership. Still another was rejected because of letters stating that they were slow pay.

The importance of using checkings to verify claims of assets in balance sheets cannot be over-estimated. It undoubtedly has prevented heavy losses to the banks in many instances, and has made possible judicious selection of paper by establishing a background. By reading bank and trade checkings closely and considering from whom they come, the banker is able to build a sound structure on which to base his credit decisions.

Checking letters occasionally leave the banker buying commercial paper with the impression that the corporation's financial position is so involved with other companies with which there is some relationship that its exact position is uncertain and its exact status is difficult to determine. Rather than thresh out the true situation, the banker often rejects the offering on the basis that he does not care to purchase paper which might in some way become complicated, or prove to have back of it less assets than are ascertainable in an ordinary investigation.

Part Bank Balances Play.—Since the banker has a primary interest in bank balances it is but natural that when a discount committee is selecting commercial paper it looks well into this angle of the risk's financial position. It is not that the companies whose paper is to be bought have any direct commercial banking connection with the purchasing institution, or that any account will be opened, but rather because the cash balances are a reflection of financial stability. When a discount committee finds a concern with current assets of nearly $1,000,000, with but $9,000 or $12,000 cash balances, it is naturally skeptical of the working capital position even if the current ratio is better than two to one. On the other hand, too large cash

balances might be a reflection on the management, which might not be making the best use of the working capital.

In one of two cases which appeared in the analysis under discussion there was a decline of 20% in cash balances over a period of one year, as shown by the corporation's comparative balance sheet. This was a strong indication, when taken in the light of all the circumstances, that the company was slipping, and a bank's loaning committee feels its way cautiously before committing itself to the selection of such an offering. The tabulation showed that out of the 50 rejections there were 2 companies which were rejected because of inadequate bank balances.

Adequate Banking Connections.—In the analysis on page 390 there were also, it will be noted, 2 rejections because the committee did not believe the concerns had sufficient banking connections. The good paper name should be one which has several banking connections to take care of possible emergencies, and to provide a financial background for checking purposes. Sometimes there are so few banking connections it is impossible for the discount committee to secure sufficient information of what might be called a professional or technical nature upon which to form an adequate opinion of the risk. Then, too, the purchaser of commercial paper feels that it is essential that there be a well-rounded program to supply additional short-term operating funds, locally, for seasonal borrowings.

When the Amount of Outstanding Paper Lines Is Excessive.—Sometimes commercial paper offerings are refused because corporations show outstanding commercial paper lines far in excess of bank lines. This would indicate in some instances that the concern was possibly not securing sufficient funds through direct borrowings from its local banks, might be in an extended position, and might be using excessive paper issuance as a way out of a possible predicament. For this

reason the discount committee of a banking house favors the well-balanced financial program in its selection of names, and fights shy of any abnormalities in operation or significant ratios which might conceal weakness.

Interest Yield on Commercial Paper.—Last of all, when the question of safety has been disposed of, there are considerations relating to the financial return on the investment. How much is the rate or yield on commercial paper? In the foregoing analysis, out of 50 cases only one rejection was made because the rate was too low. This would indicate that bankers in selecting paper emphasized first of all the margin of safety, and considered the yield as secondary.

When all the factors are weighed in, it is obvious that the banker wishes to get the best return on his funds possible with the maximum of safety. Naturally, yield is an important factor, and in view of this fact an attempt will be made to discuss the return on commercial paper and then contrast it with that on bonds, so that the borrower may not only see the banker's standpoint from the investment angle, but also that he may see what the average rate on commercial paper loans was for a period of 25 years.

It is a matter of record that from August to October of 1920 commercial paper was sold throughout the country to yield a net return of 8% to the buying bank. It is interesting to note that only at one other time during the past 25 years has commercial paper been sold to yield such a high return, and that occurred in December of the panic year of 1907.

Statistics show that commercial paper borrowers do not normally have to pay such a high rate. In fact, in September and October of 1924, prime commercial paper sold even as low as 3%, a low yield record which had been equalled only twice in the past 25 years: (1) a steady period of about 5 months from January to May of 1916 when credit was free as a result of the large gold movement from European countries

to purchase war supplies; (2) November and December of 1914, largely the result of the smoothness in operations of the newly installed Federal Reserve Banks, and the only time in the twentieth century when paper sold as low as 2¾%.

The above rates, however, represent the two extremes. Over a period of years commercial paper has netted a return to buying banks around or slightly below 5%, as will be seen by the following table, which also means that the borrower had to pay that much for the money he received for the notes issued.

	High Yield	Low Yield	Average Yield
1920–1924	8 %	3 %	5.44%
1915–1919	6 %	2¾%	4.58%
1910–1914	6¾%	3½%	4.83%
1905–1909	8 %	3½%	4.96%
1900–1904	6 %	3½%	4.65%
Average, twenty-five years.....			4.89%

These figures were calculated from the average high and low rates which have been kept weekly by the Standard Statistics Company, Inc.[6]

A Comparison with Bond Yields.—A comparison of the net yield on commercial paper with the average yield on high-grade bonds is fully as striking as a comparison of the loss ratios between these two types of investments. At times, such as in 1924 and the early part of 1925, when short-term credit was very easy as a result of the increased lending power arising out of heavy gold importations, when there was little demand for additional commercial credit, commercial paper yielded a return somewhat lower than prime long-term securities. Such periods, however, only occur occasionally and are the exceptions.

During the five-year period from 1920 to 1924 commercial paper yielded an average return of 5.44%, while bonds gave

[6] "Relative Advantages of Investing Commercial Paper as Compared With High Grade Bonds," by National Credit Office, New York.

a net return of 5.29%, a difference of about 1/7 of 1%. During the 25-year period from 1900 to 1924, which included every phase of the business cycle—optimism, feverish activity, maladjustment, contraction, depression, and cautious growth—commercial paper yielded an average return of 4.98% and bonds 4.63%, a differential in favor of commercial paper of ¼ of 1%.[7]

It has been contended also that since banks during the past few years assumed a percentage loss on bonds and securities which was 18 times as great as on commercial paper, and since they have earned an average return over a period of years on the investments of ¼ of 1% less than on commercial paper, the use of commercial paper and this form of aiding merchants and manufacturers will continue to be popular with the banks.

Advantages of Commercial Paper to the Borrower.—Some of the advantages of the open market to the borrower are given as follows:

1. It is claimed that the borrower can, through the use of commercial paper, obtain a lower interest rate than is offered by his bank. Very frequently the open market rates are lower than bank rates, due to the possibility of distributing the loan throughout a wider territory, making it possible to take advantage of the rates prevailing in any part of the country. It is an open question, however, whether lower rates are actually secured year in and year out, since there are times, as the previous discussion revealed, when the open market rates are higher than bank rates, and the bank in times of stress frequently imposes a higher rate on the customer who has been using the open market than on the one who confines his loans solely to the bank. It must also be remembered that the note broker's commission of ¼ of 1% flat appreciably increases the open market rate.

[7] "Relative Advantages of Investing in Commercial Paper as Compared With High Grade Bonds," by National Credit Office, New York.

2. It is sometimes maintained that the open market system tends to equalize interest rates throughout the country because of the wide geographic distribution of loans. In this manner the paper of an eastern manufacturer may be bought by a western bank. The flow of temporary capital to the most urgent user thereof is thus facilitated.

3. Again, it is sometimes fallaciously asserted that the borrower is appreciably the gainer because it is no longer necessary for him to maintain on deposit with his bank 20% of his line of credit or average borrowings. Some borrowers have foolishly followed such a policy, with the result that, when the real need arose, they found that the banks were under no obligations to extend credit, and could be persuaded to do so only under the most onerous terms. No reputable note broker should permit his client to cut under the deposit requirements imposed by the bank. Still, there is some truth in the contention that if commercial paper borrowings do not make it necessary to have as many depositaries as otherwise necessary, it is possible that a concern could make its bank balances more attractive to its regular commercial banks.

4. Manifestly, by using the open market, the borrower can save his bank lines for emergency purposes, when his needs are normally greatest or when the market will not readily absorb his paper. Certainly, if the open market is being resorted to, his bank lines should be kept open. It is wholly unsafe to burn the candle of credit at both ends at the same time. Properly regarded, however, the note broker may be considered as the supplier of funds needed at the peak of the borrowing period. The open market should not be looked upon as a steady source of funds.

5. One of the most significant arguments in favor of open market borrowing is the fact that many banks are not sufficiently large to take care of the entire needs of their customers. Under such circumstances it may be highly desirable from the

point of view of all concerned to sell paper at certain times in the open market. It is a question, however, whether even if this is done, it might not be wiser to arrange bank lines sufficient to meet all needs at the peak, even though they are not necessarily utilized.

6. Some have argued that resort to the commercial paper house makes the business independent of the bank to such an extent that competition will lower bank rates and induce the banker to give better service. Perhaps the cautious use of this form of borrowing may result in certain advantages of the sort mentioned. However, it should be remembered that only preferred risks can sell their paper at a favorable rate on the open market. Such borrowers are also "preferred risks" of their bank, and hence normally secure the most favorable rates, even without resorting to the brokers.

7. Again, it has been argued that the business concern, by selling its paper on the market, is trained to think in broader terms, since it has an opportunity to benefit by the wider contacts which the open market brings. Though there may be some truth in this assertion, such gains are questionable.

8. The use of the open market has been defended on the grounds that it brings helpful "advertising" to the company which can thus sell its paper. Some say that the very fact that a loan can be raised in this way is proof of the soundness of the concern. Further, the business will thus become more generally known and consequently more avenues for business and credit will constantly develop.[8]

Also, in connection with the inconvenience incurred by the seller in answering numerous requests for information regarding his affairs from purchasing banks and others, the suggestions and constructive criticisms obtained through these channels are extremely and often vitally helpful to the concern selling paper.

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[8] E. A. Lincoln, Applied Business Finance.

9. It is further alleged, and with some degree of truth, that concerns favorably known to the open market have little difficulty in arranging for permanent financing, if desired.

10. By keeping customary balances with lines open, there is more than the usual obligation on the part of its own banks to take care of the customer should the open market tighten. Thus, it is claimed, the direct borrowing position is strengthened.

11. And lastly, it is contended that many industrial concerns are not able managers in their contact with banks. The note brokers are often of inestimable assistance in this respect.

Some Abuses and Disadvantages of Open Market Borrowing.—A wise philosopher once remarked that for every advantage there was a balancing or neutralizing disadvantage. In the usage of commercial paper there are some drawbacks, some limitations which arise out of open market borrowing which are the result of an improvident use of that medium of financing, rather than of any intrinsic weakness in the system itself. Obviously, if a merchant favors one form of financing and uses the open market to such an extent that he allows his commercial bank balances to drop off, and neglects his personal contact with the officials of the banks, it is only natural that when an emergency arises, he cannot hope for 100% co-operation, since the financial responsibilities and burdens have not been such as to warrant it.

One gets out of anything usually what one puts into it. So with banking relations. If borrowers expect more from business relationships than they put into them, they may expect to be disappointed. While the commercial paper broker may be regarded as a convenient financial expedient to resort to in financing the peak of the season, it does not follow that the borrower can expect satisfactory results in the long run if he fails to save his commercial bank lines for an emergency,

seeks the borrowing limit from all his banking connections, and then trusts to Providence to pull him through when a crisis arises. Nor can it be expected that the commercial banker is going to risk his depositor's money to aid in a dire emergency the commercial borrower who, without the financial need, uses the open market simply to save a quarter per cent on his loans, when money is plentiful and rates are low, to the detriment of the banker, who has funds to loan in ample amounts, but who at times finds he is unable to meet the open market rates, much as he would like to do so to hold the customer's business.

Again, the very nature of open market borrowings is impersonal in character. When the loans are due, they must be paid; there is no personal element entering into the transaction, none of the intimate contact which is possible and necessary in commercial banking relationships. For the user of the open market these considerations must be weighed, and no more should be expected from open market borrowing than is logical to expect.

Advantages of Commercial Paper to the Investing Commercial Banker.—Foremost among the advantages which, it is maintained, prove significant to the banker are:

1. Experience proves that the returns on funds invested are assured.

It is evident that if all paper names were purchased indiscriminately without credit investigation, buying banks would not lose in normal years in excess of 20 cents on every $1,000 put out. Moreover, a loss of 47 cents is practically nil compared with an average interest-return of $4 per $1,000 invested per annum, amounting to about 1% of the yield and 1/20 of 1% of the investment.

With reasonable credit supervision and average judgment, the losses would be even less, while the losses where credit supervision is excellent are absolutely negligible—particularly

over a period of years. Records show that no bank in the United States has ever become insolvent, or even temporarily embarrassed financially, through the default of notes purchased in the open market.

2. The time of the return of funds put out is an advantage. Second only to the certainty of the return of the funds invested in open market paper is the clock-like precision with which it is paid at maturity, irrespective of the economic conditions existing at the time. There is no obligation to renew commercial paper; it is automatically paid when due, at par. Whether money is tight or free, there is no depreciation. Should bankers have unexpected requirements for funds before the maturity of this paper, it may be instantly rediscounted with corresponding banks, or 90 days before maturity, with Federal Reserve Banks, as the credit of open market names is universally known.

With the exception of a period similar to August to November of 1914, when the New York Stock Exchange was closed, there is always a ready market for all high-grade listed securities. Funds invested in bonds, however, are seldom available without serious depreciation, in times of stringency when liquid funds have their greatest value.

3. Profit earned on paper has proved to be satisfactory. During the past 25 years the average interest rate on commercial paper has been ¼ of 1% higher than the average return on high-grade bonds. Banks must pay a charge of $4 per $1,000 for buying and selling bonds listed on the New York Stock Exchange. This charge amounts to 2/5 of 1% if bonds are held one year, and this with the higher average yield gives a differential of slightly more than ½ of 1% return in favor of open market paper.

Interest rates are low on commercial paper when money is free and bonds are high. As money tightens, the market price of bonds goes off and a liquidation to meet a larger percentage of direct loans results in serious loss. A drop of one point in

a 5% bond brings its yield to about 3⅗% if held one year, a drop of two points reduces its yield to approximately 2⅗%.

4. The indirect profit on paper proves valuable. A bank intelligently buying open market paper is constantly in touch with conditions in every industry and with conditions in every part of the country. This information is invaluable to banks as a basis for comparative judgment on their direct discounts. Banks are enabled to come in close contact with important mercantile concerns whose paper is purchased.

The contact with the open market develops a very broad credit and trading intelligence. This knowledge is essential in inter-bank relationship.[9]

Distinct Function of the Commercial Paper House.—Today the commercial paper house performs a distinct function in the financial system of the United States. While in certain respects their work, as already noted, appears to be similar to, and in a sense, competitive with that of the commercial banks, the truth is that they render an essentially different service, one that no other financial agency is equipped to perform. A valuable co-ordinating unit in our financial system, it is only because the business is comparatively young that the service it performs has not yet been clearly differentiated, in the minds of many, from that performed by the commercial banks. The tremendous growth it has had in the few decades that measure its entire history, and the constantly increasing number of banks and corporations that are availing themselves of its advantages, all indicate its vital importance in our financial organization.

The general public has very little knowledge of the vast amount of credit advanced by the commercial paper houses, because the business is conducted on a strictly confidential basis both as regards the borrower and purchaser. The re-

[9] "Relative Advantage of Investing in Commercial Paper as Compared with High Grade Bonds," National Credit Office,

ports of the Federal Reserve Bank of New York show that the principal houses have had outstanding during the past 3 years as much as $1,200,000,000 of paper at a time, and a monthly average for the period of over $900,000,000.[10]

The following table helps to visualize the gradual growth in the number of active borrowers and the recent reduction in volume of paper sold.

	Active Concerns Jan. to Aug.	Paper Sold Jan. to Aug.
1922	1923	$1,508,000,000
1923	1821	1,672,000,000
1924	2247	1,698,000,000
1925	2487	1,531,000,000

It would appear that the phenomena revealed in the above table are attributed to 2 primary facts: (1) A greater number of the representative business enterprises are realizing the distinct advantages in obtaining part of their credit on the open market; (2) the low rates carried by the commercial paper during the first 6 months of the year 1925, ranging from 3½% to 4¼% and averaging about 3¾%, retarded the usual purchases of the outlying banks. In 1926, 2743 important business enterprises offered their promissory notes on the open market. While there has been a nominal increase in the number of concerns active in the open market during the past 3 years, there has been a tendency toward somewhat smaller borrowings. In 1924 the average open market borrower obtained $946,000 credit from outside banks, in 1925 about $784,000, and in 1926 approximately $704,000.

Recent Losses on Commercial Paper.—The stability of commercial paper was best demonstrated during the recent period of deflation. There was no more trying period in American commercial and industrial life than that which existed in 1920-21. Notwithstanding this unprecedented con-

[10] Walter McAvoy, The Economic Importance of the Commercial Paper House, pp. 1, 2.

dition, losses assumed by banks on open market investments were lower than those taken on any other form of mercantile investment. During the more normal business conditions of the past few years the open market record has been even more favorable.[11]

While no commercial paper house can possibly guarantee its paper, yet no reputable house, on the other hand, attempts to evade the moral responsibility implied by its recommendation. Realizing this, the conservative house is continually gathering credit information and recording and studying the progress of risks taken on, to be sure that their soundness is being maintained.

Indispensable Part of Banking System.—Under our present existing financial organization the commercial paper houses will always be indispensable to our banking system because the banking facilities of any one section of the country cannot be made to fit exactly the credit needs of that section at all times, since they usually fluctuate widely with the seasons. In one sense, the commercial paper houses may thus be regarded as banks at large, serving all sections, furnishing credit facilities to one section where it would be unprofitable to establish additional banks permanently, and supplying loans to another where credit facilities are temporarily excessive. Since the loans of brokers furnish investment continuously for huge supplies of funds, the absence of the brokers under present conditions would mean, in sections where money was scarce, producing high interest rates and a demand for more banking facilities. Hence the broker actually controls and furnishes banking capital and deposits too, since he makes unnecessary a surplus supply which would have to be taken from other fields of investment. The commercial paper house has grown to be an integral part of our banking system, and is directly instru-

[11] "Relative Advantages of Investing in Commercial Paper as compared with High Grade Bonds," National Credit Office.

mental in supplying the credit needs of a considerable percentage of our current business operations.[12]

A great co-ordinator of credit thought and research, a splendid and practical meeting ground for the large city bank and the small country bank, the commercial paper market is the link between the leading industrial concerns and the entire banking system of the country—a valuable aid to the commercial borrower.

[12] Walter McAvoy, The Economic Importance of the Commercial Paper House, p. 7.

CHAPTER XIX

ANALYSIS OF BALANCE SHEETS IN ACTUAL LOAN APPLICATIONS

There follow in this chapter 27 financial statements of concerns which applied to banks throughout the country for open market loans but were refused for reasons pointed out. In considering these statements the writer has purposely confined his observations to the balance sheet position, and has not attempted to go into the problems which arise in the analysis of surplus accounts, or the profit and loss statements. The latter would throw open the question of a complete analysis of statements which space limits will not permit here.

It is important to point out further that the reasons given for the rejections by the discount committees, at the time are outlined substantially as they appeared on record. Doubtless many of the risks shown have changed materially in their financial position, and the same companies in many instances have since been favorably considered for accommodations by reason of their greatly strengthened condition, and the progress made under improved business conditions.

The statements were selected with the realization that in passing upon commercial paper risks, banks are more critical and exacting in their requirements than in the case of over-the-counter loans, and therefore, while some criticisms are only slight, the name can be returned to the broker within the 10-day option period, and a new note taken on option as well. Consequently in presenting the causes for rejections it is important to mark them out more clearly, and they should suggest some of the things the banker thinks about when passing upon financial statements.

Taking into consideration, also, the independent position of the commercial banker in passing upon commercial paper loans, having no obligations to the prospective borrowers for balances maintained, it must be emphasized that the fundamental principles of credit analysis are the same, when applied to commercial paper loans as to loans made to depositors over the counter.

In observing, then, the weaknesses pointed out in the statements to follow and those suggested throughout the previous chapters, the reader must understand that the cases cited are purposely emphasized, the more clearly to bring home the points desired to be made, and that any exaggerations or assumptions made, by way of suggesting possible weaknesses, should be accepted generously by the reader, in the spirit in which they are presented.

It is important to note, further, that the statements used are those of actual companies which have been sufficiently altered to conceal their identity. At the same time, the ratios have been preserved intact, so that students of finance may observe the relationship between the items appearing therein and draw their own conclusions.

In some instances comments are made concerning declining or low bank balances. It is necessary to take into consideration in such cases that in some states, as Ohio, there is a heavy tax on bank balances, and that consequently there is a tendency to show less in that item on the statement where such taxes prevail. In analyzing the statements, reference to such laws has been purposely ignored. The 27 statements were selected from the 50 analyzed and referred to in the preceding chapter (page 390). While there were other causes besides those given in the analysis, which influenced the discount committees in their decisions, those shown, taken in the light of all the circumstances in each case, were the deciding factors for rejection and, as such, are of interest to the commercial borrower and the banker.

The statements in the analysis and the 27 to follow selected for illustration are of value also in that they represent rejections uninfluenced by personal considerations, and based upon the following facts gathered in good faith by the credit departments of the financial institutions passing upon the loans, and commercial paper houses negotiating the sale of the notes.

These statements were not selected from the files of any particular bank, nor were the rejections all made by any one banker. Doubtless the reader may not agree in every instance with the decisions made by the discount committees which passed upon the statements, but their decisions are faithfully rendered, just as they appeared in the records and are submitted as a matter of practical interest. Where loans were rejected for reasons outside the statement the writer comments on the favorable points in the statements, by way of suggesting the propriety of looking for the good points as well as the bad.

Gas Engine and Farm Implement Manufacturing Company.—This is an interesting case in which a concern shows by a comparative analysis of the statements for the three-year period a loss of cash and a great decline in the ratio of current assets to current liabilities. It is noted also that notes payable showed a considerable increase over previous years, which, coupled with the decrease in cash, indicate a loss in working capital.

Sales were but $1,805,193, against a total net worth of $2,403,862. Therefore, the company must earn dividends on $100 of investment for every $74 of sales. On this basis there is a handicap to profitable operation caused by insufficient sales.

The capital is $1,000,000 and surplus is $1,403,862. The surplus might be properly capitalized, in part, as paper is offered on plain note; or principal owners should endorse to make surplus available, even if it is largely drawn out in dividends.

While cash and the current ratio have shown a marked decrease, there is still a wide margin of protection for creditors with an investment of $2,403,862 against total liabilities of $645,779. There is no mortgage. If the entire business were sold at 26 cents on the dollar, all creditors would be paid.

However, the December 31, 1926, statement shows excessive inventories, totalling $1,914,350 against sales for the whole year of only $1,805,193—considerably more than one year's supply. The odd amount of notes payable indicates that they *might* have given notes for merchandise bought. After due consideration to this name from all possible angles the committee decided to hold off.

CORPORATION

GAS ENGINE, AND FARM IMPLEMENT MANUFACTURING COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	12/31/24	12/31/25	12/31/26
Quick Assets	2,137,234	2,467,876	2,636,703
Current Liabilities	191,717	230,474	645,779
Ratio Q. A. to Liabilities	11.13 to 1	10.77 to 1	4.08 to 1
Surplus Quick Assets	1,945,517	2,237,402	1,990,924
Other Assets	396,841	406,345	412,938
Total Assets Less Current Liabilities	2,342,358	2,643,747	2,403,862
Less Mortgages and Reserves	60,608	70,461	
Net Worth	2,281,750	2,573,286	2,403,862
Capital—Preferred	500,000	500,000	500,000
Capital—Common	500,000	500,000	500,000
Surplus	1,281,750	1,573,286	1,403,862
	2,281,750	2,573,286	2,403,862
Total Sales	3,653,168	3,390,799	1,805,193
Net Profit or Loss			
Dividends Paid			
Chg'd off, depreciation and bad debts			
Carried to Surplus			
QUICK ASSETS:			
Cash on hand and in bank	66,244	291,467	58,952
Notes Receivable	388,563	378,938	632,648
Trade or Bank Acceptances			
Accounts Receivable	32,149	101,468	30,753
Mdse. finished	1,185,520	1,378,653	1,914,350
Mdse. unfinished			
Raw Material			
Listed Stocks and Bonds	464,800	317,350	
OTHER ASSETS:			
Real Est. Plant, etc.	364,958	258,228	264,928
Machinery and Tools	126,995	138,967	139,617
Goodwill, Patents, Patterns, etc.	100	100	
Due from Officers, etc.			
Unlisted Stocks and Bonds			
Deferred Charges			
Teams, Wagons, Fuel, etc.	4,788	9,050	8,393
CURRENT LIABILITIES:			
Notes Payable	85,835	134,371	530,053
Trade or Bank Acceptances			
Accounts Payable	55,867	44,176	64,333
Individual's Deposits			
Div. & Com.	50,015	51,927	51,393
OTHER LIABILITIES:			
Mortgages			
Reserve Accounts	60,608	70,461	
	Outstanding through Commercial Paper Brokers. 4/1/26 $210,000		

Wide Print Cloths Manufacturing Company.—In analyzing this statement and making a comparison the following conditions are observed:

1. A decline in the current ratio of quick assets to quick liabilities, indicating a less favorable condition.
2. A decrease in total quick assets, which indicates a loss in working capital.
3. An increase in quick liabilities, as expressed in notes and accounts payable.
4. And a far less favorable liquidating condition as reflected by debts of $1,347,998 against a net worth of $2,278,266, as compared with debts of $782,810 against a net worth of $2,928,104 in the previous statement.

The odd amount of notes payable item might indicate that notes were being given for merchandise, which should be investigated. There is a decrease in the surplus of about $650,000 during the year. This is a considerable shrinkage and requires close scrutiny.

Again, there is shown at the end of the year a new item, "Due from officers $254,664." This is in spite of heavy loss and increased debt. This might indicate lack of confidence in the company by those who own it and who may have overdrawn their accounts in lavish manner—probably to protect themselves. The shift of a large amount of accounts into notes in the later statement is also important and requires an explanation. It might indicate among other things a change in sales policy. The same criticism also holds regarding the disproportionate relationship of capital to surplus for an open market note, unprotected by endorsements of the principal owners.

CORPORATION WIDE PRINT CLOTHS MANUFACTURING COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	10/2/25	10/2/26
Quick Assets	3,059,908	2,734,534
Current Liabilities	782,810	1,347,988
Ratio Q. A. to Liabilities	3.91 to 1	2.03 to 1
Surplus Quick Assets	2,277,098	1,386,546
Other Assets	651,006	891,720
Total Assets Less Current Liabilities	2,928,104	2,278,266
Less Mortgages and Reserves		
Net Worth	2,928,104	2,278,266
Capital—Preferred	449,200	449,200
Capital—Common	283,400	283,400
Surplus	2,195,504	1,545,666
	2,928,104	2,278,266
Total Sales		6,200,000
Net Profit or Loss		
Dividends Paid		
Chg'd off, depreciation and bad debts		
Carried to Surplus		
QUICK ASSETS:		
Cash on hand and in bank	1,864,262	1,429,605
Notes Receivable		754,471
Trade or Bank Acceptances		
Accounts Receivable	713,462	60,172
Mdse. finished		
Mdse. unfinished	482,184	489,286
Raw Material		
Listed Stocks and Bonds		1,000
OTHER ASSETS:		
Real Est. Plant, etc.	646,001	632,911
Machinery and Tools		
Goodwill, Patents, Patterns, etc.		
Due from Officers, etc.		254,664
Unlisted Stocks and Bonds	5,005	4,145
Deferred Charges		
CURRENT LIABILITIES:		
Notes Payable	410,155	607,659
Trade or Bank Acceptances		
Accounts Payable	351,946	490,329
Individual's Deposits		
Res. for Taxes	20,709	250,000
OTHER LIABILITIES:		
Mortgages		
Reserve Accounts		

Steel Mill Manufacturing Sheet Metal.—In this case the company shows a marked decrease in the ratio of current assets to current liabilities. The ratio dropped from 7.87 to 1 in 1925, to 1.90 to 1 in 1926. Such a marked change requires explanation. The surplus quick assets show an abnormal decrease, while the current liabilities were more than doubled.

It is noted further the company almost doubled its investment in fixed assets during the year at the expense of adequate working capital. This resulted in its having approximately $1,040,000 invested in fixed assets of a net worth of $1,271,737, which is too much. The working capital should be increased by a long-term bond issue on these fixed assets.

CORPORATION STEEL MILL MANUFACTURING SHEET METAL

Comparison of Statements .....

CONDENSED STATEMENT:

Date	12/31/25	4/31/26
Quick Assets	661,070	538,624
Current Liabilities	84,477	282,801
Ratio Q. A. to Liabilities	7.87 to 1	1.90 to 1
Surplus Quick Assets	576,593	255,823
Other Assets	622,394	1,065,994
Total Assets Less Current Liabilities	1,198,987	1,321,817
Less Mortgages and Reserves	9,519	50,080
Net Worth	1,189,468	1,271,737
Capital—Preferred	308,000	425,800
Capital—Common	510,456	529,506
Surplus	371,012	316,431
	1,189,468	1,271,737
Total Sales for first Nine Months	700,000 As of Nov. were 60% o	1st Sales f previous year.
Net Profit or Loss		
Dividends Paid		
Chg'd off, depreciation and bad debts		
Carried to Surplus		
QUICK ASSETS:		
Cash on hand and in bank	115,768	11,101
Notes Receivable	83,403	33,702
Trade or Bank Acceptances		
Accounts Receivable	68,498	58,613
Mdse. finished	1,960	379,095
Mdse. unfinished		
Raw Material		
Listed Stocks and Bonds	100,439	56,112
Investment of Ins. Funds—Notes	291,002	
OTHER ASSETS:		
Real Est. Plant, etc.	577,435	1,040,951
Machinery and Tools		
Goodwill, Patents, Patterns, etc.		
Due from Officers, etc.		
Unlisted Stocks and Bonds	28,427	
Deferred Charges	16,513	25,043
CURRENT LIABILITIES:		
Notes Payable	29,846	230,000
Trade or Bank Acceptances		
Accounts Payable	50,573	33,752
Individual's Deposits		
Accrued Expense		6,276
Res. for Taxes	4,058	12,773
OTHER LIABILITIES:		
Mortgages		
Reserve Accounts	9,519	50,080

Threshing Machine Manufacturing Company.—When a comparative analysis is made of this company over a four-year period it is found that its progress has not been particularly good. It is observed that net worth decreased $677,462 in one year. Its current liabilities increased during the period, but the total quick assets do not show as wholesome an expansion as they should for the period. Notes payable increased materially.

The trend shown from the comparative figures is one of retrogression rather than progress, which is evidenced by the current ratio, the net worth, quick assets and surplus.

CORPORATION A Threshing Machine Manufacturing Company

Comparison of Statements .....

Condensed Statement:

Date	12/30/23	12/30/24	12/30/25	12/30/26
Quick Assets	5,098,032	5,594,740	6,197,675	5,969,497
Current Liabilities	986,943	1,414,952	1,995,044	2,363,955
Ratio Q. A. to Liabilities	5.16 to 1	3.95 to 1	3.11 to 1	2.53 to 1
Surplus Quick Assets	4,111,089	4,179,788	4,202,631	3,605,542
Other Assets	1,256,815	1,430,770	1,465,630	1,385,257
Total Assets Less Current Liabilities	5,367,904	5,610,558	5,668,261	4,990,799
Less Mortgages and Reserves				
Net Worth	5,367,904	5,610,558	5,668,261	4,990,799
Capital—Preferred	1,000,000	1,000,000	1,000,000	1,000,000
Capital—Common	1,562,000	1,567,000	1,587,000	1,988,900
Surplus	2,805,904	3,043,558	3,081,261	2,001,899
	5,367,904	5,610,558	5,668,261	4,990,799
Total Sales				2,915,500
Net Profit or Loss				
Dividends Paid				
Chg'd off, depreciation and bad debts				
Carried to Surplus				
QUICK ASSETS:				
Cash on hand and in bank	216,510	545,676	316,191	250,918
Notes Receivable	2,152,094	2,307,230	2,637,911	3,065,867
Trade or Bank Acceptances				
Accounts Receivable	222,278	79,528	80,628	65,340
Mdse. finished	1,073,075	1,287,093	2,967,769	1,483,072
Mdse. unfinished				
Raw Material	1,292,569	1,278,921	182,500	947,532
Listed Stocks and Bonds. U. S.	136,750	88,700		143,982
Adv. to branch houses	4,755	7,593	12,676	12,687
OTHER ASSETS:				
Real Est. Plant, etc.	1,029,278	1,100,529	1,253,024	1,198,144
Machinery and Tools				
Goodwill, Patents, Patterns, etc.				
Due from Officers, etc.	10,305		5,800	7,000
Unlisted Stocks and Bonds				
Deferred Charges		224,287	91,027	55,876
Farm Lands	217,232	105,954	115,779	124,236
CURRENT LIABILITIES:				
Notes Payable	547,001	763,100	1,551,800	2,060,822
Trade or Bank Acceptances				
Accounts Payable	53,357	288,558	173,319	70,277
Individual's Deposits	84,028			
Commission Certificates	183,466	163,104	219,925	232,856
Res. for Div., etc.—Notes	119,090	200,490	50,000	
OTHER LIABILITIES:				
Mortgages				
Reserve Accounts				

Outstanding with Commercial Paper Brokers.

12/1/25	6/23/26
515,000	620,000

Wholesale Banana Dealers.—A glance at the statement shows nearly $3,000,000 in merchandise, which is excessive, and $7,771,000 of net worth represented by fixed investment, which is also excessive.

An analysis of this company shows large advances for cultivation of crops. This item is nearly as large as the amount in accounts receivable. Comparing the cash and the rest of the quick assets with the current liabilities which have to be met, it would seem that if the money sunk in the "advances" is not realized, it would possibly handicap the company's operation. Just how much this might embarrass the company in the event of loss is hard to tell, yet if the advances were eliminated, there would still be $4,641,000 to pay $2,199,000, which is ample. Nevertheless the company's paper was rejected. It may have been that the type of business and its hazards did not appeal to the bank.

CORPORATION WHOLESALE BANANA DEALERS

Comparison of Statements .....

CONDENSED STATEMENT:

Date		6/30/26
Quick Assets		5,249,001
Current Liabilities		2,199,804
Ratio Q. A. to Liabilities		2.39 to 1
Surplus Quick Assets		3,049,197
Other Assets		7,771,423
Total Assets Less Current Liabilities		10,820,620
Less Mortgages and Reserves		1,924,914
Net Worth		8,895,706
Capital—Preferred		
Capital—Common		6,500,000
Surplus		2,395,706
		8,895,706
Total Sales		10,000,000
Net Profit or Loss		
Dividends Paid		
Chg'd off, depreciation and bad debts		
Carried to Surplus		
QUICK ASSETS:		
Cash on hand and in bank		160,030
Notes Receivable		622,580
Trade or Bank Acceptances		
Accounts Receivable		843,447
Mdse. finished		1,123,235
Mdse. unfinished		1,836,465
Raw Material		
Listed Stocks and Bonds, U. S.		55,000
Advances for Cultivation of Crops		608,243
OTHER ASSETS:		
Real Est. Plant, etc.		7,218,221
Machinery and Tools		
Goodwill, Patents, Patterns, etc.		
Due from Officers etc.		
Unlisted Stocks and Bonds		203,300
Deferred Charges		
Bd. of Com. Port of New Orleans—Ware		349,902
CURRENT LIABILITIES:		
Notes Payable		790,600
Trade or Bank Acceptances		70,094
Accounts Payable		589,110
Individual's Deposits		
Equip. Notes up to and inc. Dec. 1, 1921		750,000
OTHER LIABILITIES:		
Mortgages		1,647,000
Deferred Credits to Operation		74,343
Reserve Accounts		203,571
	1,215,000 (July, 1926)	Outstanding through Commercial Brokers.

Commission Sole Leather Company.—A glance at the statement shows a declining ratio of current assets to current liabilities, but this is not so important in this instance, on account of the increase in cash.

It is noted that this company has no inventory, but carries excessive advances on leather. It is customary for this type of enterprise to farm out the raw leather to be finished. To cover part of the cost they make advances to those concerns doing the work for them.

It is important to observe that the debts are in excess of the company's own investment, which is an unfavorable feature from a liquidating standpoint; and that too much of the current assets are represented by an item the collectibility of which is dependent somewhat on the market value of leather, a commodity which has had some wide fluctuations in price.

CORPORATION COMMISSION SOLE LEATHER COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	12/30/25	12/30/26
Quick Assets	8,182,443	9,195,099
Current Liabilities	3,912,927	4,793,326
Ratio Q. A. to Liabilities	2.09 to 1	1.92 to 1
Surplus Quick Assets	4,269,516	4,401,773
Other Assets		
Total Assets Less Current Liabilities		
Less Mortgages and Reserves		
Net Worth	4,269,516	4,401,773
Capital—Preferred	1,850,000	1,850,000
Capital—Common	1,150,000	1,150,000
Surplus	1,269,516	1,401,773
	4,269,516	4,401,773
Total Sales	28,600,000	17,000,000
Net Profit or Loss		130,000
Dividends Paid		
Chg'd off, depreciation and bad debts		
Carried to Surplus		
QUICK ASSETS:		
Cash on hand and in bank	407,982	825,761
Notes Receivable		
Trade or Bank Acceptances		
Accounts Receivable	3,255,472	2,648,745
Cash Advances on Leather Hides	4,518,989	5,720,593
Mdse. unfinished		
Raw Material		
Listed Stocks and Bonds		
OTHER ASSETS:		
Real Est. Plant, etc		
Machinery and Tools		
Goodwill, Patents, Patterns, etc		
Due from Officers, etc		
Unlisted Stocks and Bonds		
Deferred Charges		
CURRENT LIABILITIES:		
Notes Payable	3,537,600	4,326,760
Trade or Bank Acceptances		
Accounts Payable	375,327	466,567
Individual's Deposits		
OTHER LIABILITIES:		
Mortgages		
Reserve Accounts		
	Outstanding through Commercial Paper Brokers. 2/1/26	1,415,000

Flour Milling Company.—A comparison of the statements for the 3 years is interesting. A declining ratio of quick assets to quick liabilities is observed. This is not regarded as a healthy sign. The decline was caused by the large increase in inventory. Analysis shows an increase in current liabilities—in notes payable. The debt is heavy and the merchandise is too large for a milling company on that date, unless the grain elevators are located in a territory where winter wheat is stored, inventories should be fairly well liquidated. The statement shows a carry over. It is of interest to note that considerable money is shown due to stockholders during the years 1924 and 1925. In 1926 nothing is shown as due them. Did the company pay this amount out of the current earnings? If so, was it advisable, considering the weakness shown in the ratio of current assets to current liabilities?

CORPORATION FLOUR MILLING COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	6/30/24	6/30/25	6/30/26
Quick Assets	945,434	1,124,944	1,359,894
Current Liabilities	278,742	469,726	686,640
Ratio Q. A. to Liabilities	3.39 to 1	2.39 to 1	1.98 to 1
Surplus Quick Assets	666,692	655,218	673,254
Other Assets	132,834	655,799	667,940
Total Assets Less Current Liabilities	1,299,526	1,311,017	1,341,194
Less Mortgages and Reserves	310,771	245,338	276,446
Net Worth	988,755	1,065,679	1,064,748
Capital—Preferred			
Capital—Common	500,000	500,000	500,000
Surplus	488,755	565,679	564,748
	988,755	1,065,679	1,064,748
Total Sales	5,671,915	4,651,494	4,639,683
Net Profit or Loss			145,882
Dividends Paid			146,814
Chg'd off, depreciation and bad debts			56,728
Carried to Surplus			
QUICK ASSETS:			
Cash on hand and in bank	17,316	38,427	25,669
Notes Receivable	30,416	29,773	9,455
Trade or Bank Acceptances			
Accounts Receivable	546,088	498,749	578,175
Mdse. finished	208,763	534,794	746,593
Mdse. unfinished			
Raw Material			
Listed Stocks and Bonds, U. S.	87,946	846	
Advances on Wheat	44,906	22,353	
OTHER ASSETS:			
Real Est. Plant, etc	304,633	306,633	308,363
Machinery and Tools	323,887	342,106	347,652
Goodwill, Patents, Patterns, etc	50	50	50
Due from Officers, etc			
Unlisted Stocks and Bonds			
Deferred Charges	714	3,460	6,775
Membership	3,550	3,550	3,550
Advances on Wheat			1,549
CURRENT LIABILITIES:			
Notes Payable	264,000	301,000	504,070
Trade or Bank Acceptances			
Accounts Payable	4,115	1,326	2,502
Individual's Deposits			
Taxes	10,627	32,047	
Wheat stored in Mnpl's		135,351	180,066
OTHER LIABILITIES:			
G. M. Palme (Endorser)	82,623	37,632	60,417
Due Other Stockholders	78,711	37,212	
Reserve Accounts	149,437	170,492	216,029
	Outstanding through Paper Brokers Aug. 23, '26		Commercial 80,000

Fertilizer Company.—Here is a statement showing a current ratio of quick assets to quick liabilities of better than four to one. Still, it was rejected. Current liabilities are less than the year before; notes payable are less, and generally speaking this is not a bad statement, yet the loan was refused because the statement submitted was too old to be accurate enough.

What constitutes an old statement? That depends upon the circumstances. In some cases a statement a week old would be too old. In most cases anything more than 6 months back is generally considered rather old, but in some corporations which have a strong reputation and have maintained good earnings over a period of years, only a yearly statement is struck off for publication. Bankers are trying to bring such companies around to the point of bringing their balance sheets down to date semi-annually. Conservative bankers are insisting more and more on up-to-date balance sheets when considering applications for loans.

CORPORATION FERTILIZER COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	7/31/25	7/31/26
Quick Assets	934,494	873,544
Current Liabilities	419,565	201,593
Ratio Q. A. to Liabilities	2.23 to 1	4.35 to 1
Surplus Quick Assets	514,929	671,951
Other Assets	214,635	208,230
Total Assets Less Current Liabilities	729,564	880,181
Less Mortgages and Reserves		
Net Worth	729,564	880,181
Capital—Preferred	250,000	250,000
Capital—Common		
Surplus	479,564	630,181
	729,564	880,181
Total Sales	844,608	1,122,415
Net Profit or Loss	185,085	183,838
Dividends Paid	46,950	20,000
Chg'd off, depreciation and bad debts		
Carried to Surplus		
QUICK ASSETS:		
Cash on hand and in bank	92,638	34,395
Notes Receivable	532,522	697,508
Trade or Bank Acceptances		
Accounts Receivable	7,096	10,056
Mdse. finished	302,238	131,585
Mdse. unfinished		
Raw Material		
Listed Stocks and Bonds		
OTHER ASSETS:		
Real Est. Plant, etc	98,086	84,645
Machinery and Tools		
Goodwill, Patents, Patterns, etc		
Due from Officers, etc		
Unlisted Stocks and Bonds	92,789	92,879
Deferred Charges		
Union Cotton Oil Co	16,365	30,706
Interest and Insurance Prepaid	7,395	
CURRENT LIABILITIES:		
Notes Payable	354,000	195,000
Trade or Bank Acceptances		
Accounts Payable	64,982	
Individual's Deposits		
Taxes Accrued		6,593
Payroll Accrued	583	
OTHER LIABILITIES:		
Mortgages		
Reserve Accounts		

Wholesale Hardware Company.—Whether or not a company is too small to be regarded as a prime risk is a matter depending largely upon what definition is used for the word "small." A discount committee may base its judgment as to the minimum size of a company upon a number of things. Some of these are: Invested capital, assets, volume of business, net worth and cash balances, all are taken into consideration. The company under consideration was regarded as too small by the bank discount committee.

In analyzing this and other statements, consideration should be given to the fact that the discount committees had a large number of companies to choose from, and that their judgment was influenced by the comparison of the standing of these concerns with that of others seeking accommodations, with a view to selecting the best from those presented. The relative size of a corporation also depends partly on the viewpoint of the committee making the selection, which reflected the experience and training of its members.

In addition, the wholesale hardware company was considered as having too few banking connections.

A portion of the liberal surplus should be capitalized to insure a well-balanced financial structure. Cash balances are very nominal, even showing an overdraft in one bank.

CORPORATION WHOLESALE HARDWARE COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date...	12/31/24	12/31/25	12/31/26
Quick Assets	556,158	439,520	547,170
Current Liabilities	45,771	66,094	239,742
Ratio Q. A. to Liabilities	12.15 to 1	6.64 to 1	2.27 to 1
Surplus Quick Assets	510,387	373,426	307,428
Other Assets		89,895	266,416
Total Assets Less Current Liabilities	510,387	463,321	573,844
Less Mortgages and Reserves	38,323	14,163	7,387
Net Worth	482,064	449,158	566,457
Capital—Preferred			
Capital—Common	243,000	243,000	271,000
Surplus	229,064	206,158	295,457
Total Sales	1,156,775	1,034,505	1,290,997
Net Profit or Loss	50,401	17,067	129,743
Dividends Paid			
Chg'd off, depreciation and bad debts			
Carried to Surplus			
QUICK ASSETS:			
Cash on hand and in bank	6,570	3,218	7,741
Notes Receivable	6,406		8,087
Trade or Bank Acceptances			
Accounts Receivable	150,539	182,152	221,107
Mdse. finished	365,477	253,300	290,649
Mdse. unfinished			
Raw Material			
Listed Stocks and Bonds, U. S	27,166	850	834
OTHER ASSETS:			
Real Est. Plant, etc		64,000	225,997
Machinery and Tools	NONE		
Goodwill, Patents, Patterns, etc			
Due from Officers, etc		25,895	
Unlisted Stocks and Bonds			950
Deferred Charges			3,698
Other Assets			35,770
CURRENT LIABILITIES:			
Notes Payable	11,000	23,300	207,730
Trade or Bank Acceptances			
Accounts Payable	34,771	42,794	24,542
Individual's Deposits			
Overdraft (Bank)			7,468
OTHER LIABILITIES:			
Mortgages			
Accrued Taxes			7,387
Reserve Accounts, Due Officers	38,323	14,163	

General Merchandise Business.—The comparative balance sheet of this company shows the following good points:

1. Strong current ratio
2. No notes payable
3. Ample quick assets to pay small current obligations

It is noted, however, that the concern was located in a small town in Texas, and the only bank in the town is controlled by the subject company. Due to the inability to get disinterested opinions in order that credit references might be properly weighed, the committee declined the paper, being unable to obtain enough disinterested sources from which to obtain unbiased, accurate information. Furthermore, their total available bank credit was considered too small to tide them over their peak borrowing period.

CORPORATION — A General Merchandise Business

Comparison of Statements .....

Condensed Statement:

Date	12/31/24	12/31/25	12/31/26
Quick Assets	1,672,062	1,337,666	1,365,531
Current Liabilities	526,351	212,395	116,181
Ratio Q. A. to Liabilities	3.17 to 1	6.29 to 1	11.75 to 1
Surplus Quick Assets	1,145,711	1,125,271	1,249,350
Other Assets	790,869	818,639	827,879
Total Assets Less Current Liabilities	1,936,580	1,943,910	2,077,229
Less Mortgages and Reserves	106,935	137,155	184,620
Net Worth	1,829,645	1,806,755	1,892,609
Capital—Preferred	1,000,000	1,000,000	1,000,000
Capital—Common	500,000	500,000	500,000
Surplus	329,645	306,755	392,609
Total Sales	4,948,488	2,485,478	2,525,446
Net Profit or Loss	Loss 14,165	Profit 33,997	Profit 171,814
Dividends Paid			
Chg'd off, depreciation and bad debts			
Carried to Surplus			
QUICK ASSETS:			
Cash on hand and in bank	105,353	90,236	140,259
Notes Receivable	200,860	278,855	260,689
Trade or Bank Acceptances			
Accounts Receivable	307,848	213,624	173,160
Mdse. finished	1,046,621	748,552	784,000
Mdse. unfinished			
Raw Material			
Listed Stocks and Bonds, U. S.	11,378	6,396	6,256
Drafts Out for Collection			622
OTHER ASSETS:			
Real Est. Plant, etc.	586,178	520,136	530,925
Machinery and Tools		95,397	93,306
Real Estate			
Due from Officers, etc.	6,224	28,086	
Unlisted Stocks and Bonds	79,450	64,224	60,087
Other Inventory	6,933	5,070	5,400
Unexpired Insurance	14,986	13,526	
Treas. Stock	92,200	92,200	95,000
Sundry Acct's Receivable	4,896		31,407
CURRENT LIABILITIES:			
Notes Payable	360,000	100,000	
Customers' Credit Balances	49,352		14,520
Accounts Payable	14,095	83,331	41,955
Individual's Deposits	60,897	25,631	29,415
Accrued Interest and Taxes	42,006	3,432	30,490
OTHER LIABILITIES:			
Mortgages	25,747		
Reserves for Losses	81,188	134,666	162,649
Reserve Accounts, Depreciation			

Hardware Manufacturing Company.—In this case it will be observed that the capital structure is not especially strong, there being but $350,000 in the capital account and too great an amount in surplus. Some of the surplus should be converted into capital to prevent it from being paid out in dividends. The sales volume is too small in proportion to the inventory.

This concern was not known to the discount committee, which concluded that the concern's borrowings might well be confined to the institutions located in the same large city, in a position to more properly watch the trend of its affairs.

CORPORATION HARDWARE MANUFACTURING COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	12/31/25	12/31/26
Quick Assets	1,528,639	1,706,976
Current Liabilities	768,869	821,048
Ratio Q. A. to Liabilities	1.99 to 1	2.08 to 1
Surplus Quick Assets	759,770	885,928
Other Assets	85,551	89,971
Total Assets Less Current Liabilities	845,321	975,899
Less Mortgages and Reserves		
Net Worth	845,321	975,899
Capital—Preferred	100,000	100,000
Capital—Common	250,000	250,000
Surplus	495,321	625,899
Total Sales	1,896,539	2,680,936
Net Profit or Loss		
Dividends Paid		
Chg'd off, depreciation and bad debts		
Carried to Surplus		
QUICK ASSETS:		
Cash on hand and in bank	36,611	51,641
Notes Receivable	18,212	27,708
Trade or Bank Acceptances		
Accounts Receivable	301,729	335,221
Mdse. finished	1,164,447	1,288,905
Mdse. unfinished		
Raw Material		
Listed Stocks and Bonds	7,640	3,500
OTHER ASSETS:		
Real Est. Plant, etc	35,232	38,933
Machinery and Tools		
Goodwill, Patents, Patterns, etc		
Due from Officers, etc		
Unlisted Stocks and Bonds	38,625	37,626
Deferred Charges	11,695	13,413
CURRENT LIABILITIES:		
Notes Payable	756,000	716,400
Trade or Bank Acceptances		
Accounts Payable	11,350	97,648
Individual's Deposits	1,519	7,000
OTHER LIABILITIES:		
Mortgages		
Reserve Accounts		
	Outstanding with Commercial Paper Brokers 4/1/26	457,500

Farm Implement Manufacturing Company.—This company shows a net worth of only a little over $500,000. Sales volume is also too small to warrant their carrying such a large inventory in the face of adverse conditions in the farming districts.

It was also felt by the discount committee that these small independent manufacturers would not fare very well in the immediate future owing to the highly competitive conditions existing in the industry at the time.

CORPORATION FARM IMPLEMENT MANUFACTURING COMPANY

Comparison of Statements

CONDENSED STATEMENT:

Date	7/1/25	7/1/26
Quick Assets	552,973	540,407
Current Liabilities	85,148	113,767
Ratio Q. A. to Liabilities	6.51 to 1	4.74 to 1
Surplus Quick Assets	467,825	426,640
Other Assets	232,208	231,763
Total Assets Less Current Liabilities	700,033	658,403
Less Mortgages and Reserves		
Net Worth	700,033	658,403
Capital—Preferred	257,250	253,350
Capital—Common	326,000	326,000
Surplus	116,783	79,053
	700,033	658,403
Total Sales		400,000
Net Profit or Loss		
Dividends Paid		
Chg'd off, depreciation and bad debts		
Carried to Surplus		
QUICK ASSETS:		
Cash on hand and in bank	21,335	34,784
Notes Receivable	10,255	27,488
Trade or Bank Acceptances		
Accounts Receivable	164,706	107,816
Mdse. finished	356,676	370 317
Mdse. unfinished		
Raw Material		
Listed Stocks and Bonds		
OTHER ASSETS:		
Real Est. Plant, etc.	125,934	117,510
Machinery and Tools	59,829	71,110
Goodwill, Patents, Patterns, etc.	40,326	37,025
Furniture and Fixtures	6,119	6,119
Unlisted Stocks and Bonds		
Deferred Charges		
CURRENT LIABILITIES:		
Notes Payable	82,600	113,085
Trade or Bank Acceptances		
Accounts Payable	2,548	682
Individual's Deposits		
OTHER LIABILITIES:		
Mortgages		
Reserve Accounts		

Manufacturers of Toys and Electrical Goods.—Here is a December 31 statement with an inventory of almost $600,000 against sales volume of $1,700,000. The committee felt that a toy company should be pretty well liquidated at the close of the holiday season. This is an instance where special consideration is given to the seasonal condition of a business.

It will be further noted that there was a big shrinkage in cash balances for the year 1926 over the year 1925. This may have been due to various causes. The decrease in accounts payable may indicate that the company used a good part of its cash to wipe out its major payables about the time of taking off the statement. Again, it might be that the decrease in cash was due to slow collections. Does the listing of notes receivable for 1926 and not for 1925 indicate that notes were accepted because of slow payments for the purpose of protection against weak creditors, or was it a mere change in the policy of the company to accept notes in payment? These are some of the questions it might be well to clear up in analyzing this statement.

CORPORATION MANUFACTURERS OF TOYS AND ELECTRICAL GOODS

Comparison of Statements .....

CONDENSED STATEMENT:

Date	12/31/25	12/31/26
Quick Assets	1,192,724	984,565
Current Liabilities	471,904	347,417
Ratio Q. A. to Liabilities	2.52 to 1	2.83 to 1
Surplus Quick Assets	720,820	637,148
Other Assets	295,119	353,115
Total Assets Less Current Liabilities	1,015,939	990,263
Less Mortgages and Reserves	75,000	75,000
Net Worth	940,939	915,263
Capital—Preferred	400,000	400,000
Capital—Common	250,000	251,000
Surplus	290,939	264,263
	940,939	915,263
Total Sales		1,710,086
Net Profit or Loss		155,169
Dividends Paid		
Chg'd off, depreciation and bad debts		
Carried to Surplus		
QUICK ASSETS:		
Cash on hand and in bank	305,214	66,220
Notes Receivable		47,516
Trade or Bank Acceptances		
Accounts Receivable	440,964	307,105
Mdse. finished	434,846	563,524
Mdse. unfinished		
Raw Material		
Listed Stocks and Bonds	11,700	200
OTHER ASSETS:		
Real Est. Plant, etc.	214,968	250,559
Machinery and Tools		
Goodwill, Patents, Patterns, etc.		
Due from Officers, etc.		
Unlisted Stocks and Bonds	73,188	73,111
Deferred Charges	6,963	29,446
CURRENT LIABILITIES:		
Notes Payable	274,000	286,500
Trade or Bank Acceptances		
Accounts Payable	197,904	35,917
Individual's Deposits		
Federal Taxes		25,000
OTHER LIABILITIES:		
Mortgages	75,000	75,000
Reserve Accounts		
	Sept. 29/26 410,000 Outstanding with Commercial Paper Brokers.	

Lumber, Kraft Paper, Sulphite Fibre Manufacturing Company.—This company's paper was rejected because of unfavorable checkings. One bank checking was as follows:

"We have not been altogether impressed with the progress the company has made since 1922, and, for the present, at least, we would be inclined to give preference to other names."

Another checking reads to this effect: "The management are honest, but show too much of a tendency to spread out their activities into lines foreign to the general company business." Still another checking commented on "the weakness in the management in attempting to curb the company's over-expansion in some lines."

Attention may also be called to the following:

1. Decrease shown over the five-year period of years in the ratio of current assets to current liabilities.
2. Heavy increase in fixed assets, and a shrinkage in quick assets for the period.
3. Increase in mortgage debt.

CORPORATION LUMBER, KRAFT PAPER, AND SULPHITE FIBRE MANUFACTURING COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	11/30/22	11/30/23	11/30/24	11/30/25	11/30/26
Quick Assets	21,572,348	18,907,448	18,011,298	13,443,318	13,596,539
Current Liabilities	6,741,257	3,901,273	7,935,239	5,170,719	6,197,944
Ratio Q. A. to Liabilities	3.20 to 1	4.85 to 1	2.27 to 1	2.59 to 1	2.19 to 1
Surplus Quick Assets	14,831,091	15,006,175	10,076,059	8,272,589	7,398,595
Other Assets	26,696,625	30,678,314	34,518,792	38,715,954	43,413,707
Total Assets Less Current Liabilities	41,527,716	45,684,489	44,594,851	46,988,543	50,812,302
Less Mortgages and Reserves	15,313,142	15,597,142	16,043,504	18,603,545	12,057,483
Net Worth	26,214,574	30,087,347	28,551,347	28,384,998	38,754,819
Capital—Preferred	1,300,000	1,300,000	1,300,000	1,300,000	1,067,900
Capital—Common	2,000,000	2,000,000	2,000,000	20,000,000	20,000,000
Surplus	22,914,574	26,787,347	25,251,347	7,084,998	17,686,919
Total Sales		34,381,268	16,218,018	18,587,000	20,487,000
Net Profit or Loss					
Dividends Paid					
Chg'd off, depreciation and bad debts					
Carried to Surplus					
QUICK ASSETS:					
Cash on hand and in bank	3,882,652	2,565,268	1,424,495	1,579,392	1,234,873
Notes Receivable, Demand Loans	5,000,000	850,000			
Trade or Bank Acceptances					
Accounts Receivable	3,823,211	3,698,301	2,810,499	2,675,828	2,426,646
Mdse. finished, Inventory	5,866,192	5,107,372	7,702,426	7,041,913	8,581,866
Mdse. unfinished	594,815	1,036,760	398,227	499,348	1,050,675
Prepayments on Pulpwood					
Raw Material					
Listed Stocks and Bonds, U. S.	1,647,514	3,654,998	1,351,112	43,900	
Others	53,290	42,840	47,050	589,126	50,122
Due from Affiliated Companies	131,520	1,108,470	431,227		
Prepayments and Suspense	573,154	843,439		1,013,809	252,355
OTHER ASSETS:					
Real Est. Plant, etc.	14,778,426	17,691,163	20,432,615	21,713,544	23,707,617
Timber Lands	5,377,858	5,404,534	5,414,774	5,415,773	7,430,396
Goodwill, Patents, Patterns, etc.					
Due from Officers, etc.					
Unlisted Stocks and Bonds	6,540,341	7,582,616	10,594,539	11,586,635	11,587,634
Deferred Charges			1,923,136		
Suspense					688,057
CURRENT LIABILITIES:					
Notes Payable	3,718,000		6,400,000	3,377,600	4,885,000
Continuing Loans				157,139	
Accounts Payable	1,302,376	1,476,012	1,297,749	1,244,747	933,922
Due Officers of Company				286,924	18,877
Acc. Taxes, Int., etc.	1,188,279	2,222,366	70,769	104,308	183,495
Continuing & Long Time Loans	532,602	202,895	166,720		176,148
OTHER LIABILITIES:					
Mortgages	8,750,000	8,275,000	7,800,000	9,375,000	12,057,483
Reserve Accounts	6,563,142	7,322,142	8,243,504	9,228,545	10,456,477

Outstanding with Commercial Paper Brokers.	
6/1/26	7/1/26
1,827,500	2,917,500

Grain Elevator Company.—This is a grain elevator company. It is customary for such companies to offer notes secured by warehouse or elevator receipts, representing grain stored and held by the company. It is, moreover, customary to have such collateral registered to guarantee the quality and quantity of the grain. The company's paper was declined because of unsatisfactory bank checkings, which were as follows:

"Broker claims their receipt is registered under the laws of the state of X, but there is nothing on the document itself providing for registration in any way. . . . For this reason we are not interested in the paper, as we would only have the company itself to guarantee the quality of the grain."

"In analyzing the statement we observe that the ratio of current assets to current liabilities is not strong considering the type of business. Moreover, the notes payable item is high, while the accounts payable are less, which might indicate that the company was giving notes instead of cash to meet its merchandise bills outstanding. Despite the fact that notes are offered secured by merchandise with a margin, their own value of inventory is less than the amount of notes."

CORPORATION GRAIN ELEVATOR COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	7/31/25	7/31/26
Quick Assets	1,187,345	950,971
Current Liabilities	825,758	623,104
Ratio Q. A. to Liabilities	1.44 to 1	1.53 to 1
Surplus Quick Assets	361,587	327,867
Other Assets	1,030,531	1,030,383
Total Assets Less Current Liabilities	1,392,118	1,358,250
Less Mortgages and Reserves		
Net Worth	1,392,118	1,358,250
Capital—Preferred		
Capital—Common	1,000,000	1,000,000
Surplus	392,118	358,250
	1,392,118	1,358,250
Total Sales	None A	vailable
Net Profit or Loss to July 31	306,000	185,203
Dividends Paid	120,000	200,000
Chg'd off, depreciation and bad debts		
Carried to Surplus		
QUICK ASSETS:		
Cash on hand and in bank	333,264	190,616
Notes Receivable	87,509	197,494
Trade or Bank Acceptances		
Accounts Receivable	84,942	71,885
Mdse. finished		
Mdse. unfinished	471,321	402,335
Raw Material		
Listed Stocks and Bonds, U. S.	80,260	70,260
Accrued Interest		6,762
Open Options	130,048	11,620
OTHER ASSETS:		
Real Est. Plant, etc.	987,836	1,008,598
Machinery and Tools		
Goodwill, Patents, Patterns, etc.		
Due from Officers, etc.		
Unlisted Stocks and Bonds	36,940	13,850
Deferred Charges	5,755	7,935
CURRENT LIABILITIES:		
Notes Payable	700,000	586,344
Trade or Bank Acceptances		
Accounts Payable	120,321	35,480
Individual's Deposits		
Accrued Liabilities	5,438	1,280
OTHER LIABILITIES:		
Mortgages		
Reserve Accounts		

Buggy Manufacturing Company.—This company's paper was also rejected because of unfavorable checkings. These were as follows:

1. We have had no occasion to make a complete checking on this company for a year. Our information is not recent enough as a basis upon which to form an opinion as to the goodness of the company's open market paper now being offered.
2. Would want to see a recent statement.
3. We regret we are not in close touch with the situation at this time.

If these 3 reports were received from banks which had the company's accounts or which understood the situation, the reports are evasive and give evidence of a desire to withhold something. However, if they are from banks having no direct connections with the company and located entirely outside of its territory, they may mean nothing more than that the banks have not been offered the company's notes recently.

CORPORATION BUGGY MANUFACTURING COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	10/9/22	10/2/23	10/6/24	12/31/25	12/31/26
Quick Assets	2,005,07	2,108,683	5,265,231	3,165,549	2,735,857
Current Liabilities	551,541	829,554	1,506,518	289,521	418,157
Ratio Q. A. to Liabilities	3.63 to 1	2.56 to 1	3.48 to 1	10.96 to 1	6.54 to 1
Surplus Quick Assets	1,454,076	1,279,129	3,758,713	2,876,028	2,317,700
Other Assets	1,360,035	1,591,546	3,898,296	4,064,784	3,945,168
Total Assets Less Current Liabilities	2,814,111	2,870,675	7,657,009	6,940,812	6,262,868
Less Mortgages and Reserves	40,742	40,742	1,573,000	1,355,619	1,022,200
Net Worth	2,773,369	2,829,933	6,084,009	6,585,193	5,240,668
Capital—Preferred	622,400	617,400	3,217,700	3,108,756	2,877,500
Capital—Common	742,000	715,000	2,500,000	2,001,000	2,001,000
Surplus	1,408,969	1,497,533	366,309	475,433	362,168
	2,773,369	2,829,933	6,084,009	5,585,193	5,240,668
Total Sales	4,796,196	5,479,992	6,728,107		
Net Profit or Loss	437,088	280,230			
Dividends Paid					
Chg'd off, depreciation and bad debts					
Carried to Surplus					
QUICK ASSETS:					
Cash on hand and in bank	89,418	59,731	417,431	286,701	122,068
Notes Receivable	171,077	230,015			
Trade or Bank Acceptances					
Accounts Receivable	556,670	844,428	1,793,316	983,838	820,423
Mdse. finished	1,167,929	960,749	3,002,800	1,831,033	1,793,364
Mdse. unfinished					
Raw Material					
Equity in U. S. Bonds	20,523	13,760	9,550	63,976	
Due from Employees			42,132		
OTHER ASSETS:					
Real Est. Plant, etc.					
Machinery and Tools	406,669	311,686	3,252,802	3,205,421	3,118,129
Goodwill, Patents, Patterns, etc.	400,000	500,000	508,900	500,000	501,020
Due from Officers, etc.	55,782				
Unlisted Stocks and Bonds	319,105	350,755			
Deferred Charges, Ins.	3,722	2,111	136,594	213,484	152,534
Advances to Subsidiary Companies					
Other Assets					123,659
CURRENT LIABILITIES:					
Notes Payable			391,500		
Trade or Bank Acceptances					
Accounts Payable	165,897	289,493	396,148	59,421	157,720
Individual's Deposits	84,378	210,921	135,486	50,390	61,010
	301,266	329,140	583,385	179,710	199,426
OTHER LIABILITIES:					
Mortgages			1,500,000	1,333,400	1,022,200
Reserve Accounts, Contingencies	40,742	40,742	73,000	22,219	

Clothing Company.—Bank checkings were not altogether satisfactory in the case of this company's offerings. One of them was as follows:

"In view of the unfavorable conditions surrounding the clothing industry during 1923, we have preferred to await the issuance of the December 1923 figures, and consequently returned a small amount of the notes, which we had under consideration a short while ago."

From the foregoing it is inferred that the committee did not like the business outlook in the particular industry, particularly as the opinion above expressed came from an institution thoroughly familiar with the outlook in this line.

CORPORATION CLOTHING COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	12/31/22	1/1/23
Quick Assets	4,101,689	4,522,531
Current Liabilities	1,515,722	1,814,023
Ratio Q. A. to Liabilities	2.69 to 1	2.44 to 1
Surplus Quick Assets	2,585,967	2,708,508
Other Assets	1,452,840	1,378,709
Total Assets Less Current Liabilities	4,038,807	4,087,217
Less Mortgages and Reserves		
Net Worth	4,038,807	4,087,217
Capital—Preferred	1,500,000	1,500,000
Capital—Common	1,500,000	1,500,000
Surplus	1,038,807	1,087,217
Total Sales	None	available
Net Profit or Loss		
Dividends Paid		
Chg'd off, depreciation and bad debts		
Carried to Surplus		
QUICK ASSETS:		
Cash on hand and in bank	658,828	829,460
Notes Receivable		
Trade or Bank Acceptances		
Accounts Receivable	646,881	909,302
Mdse. finished		
Mdse. unfinished	2,788,637	2,614,823
Raw Material		
Listed Stocks and Bonds, U. S.	7,342	8,436
		152,000
Loans Receivable		8,510
OTHER ASSETS:		4,522,531
Real Est. Plant, etc	934,757	949,051
Machinery and Tools	200,834	279,658
Goodwill, Patents, Patterns, etc	150,000	150,000
Due from Officers, etc		
Unlisted Stocks and Bonds		
Deferred Charges		
Loans	167,248	
CURRENT LIABILITIES:		1,378,709
Notes Payable	409,931	608,931
Trade or Bank Acceptances		
Accounts Payable	108,759	88,894
Taxes		33,280
Commission Payable	156,696	166,747
Loans Payable	840,334	916,171
OTHER LIABILITIES:		1,814,023
Mortgages		
Reserve Accounts		

Car Manufacturing Company.—The bank checkings were also unfavorable in this case, one of which was as follows:

"We are unable to come to a very favorable conclusion as to the result of our research. You will note that while the company includes in its assets trade acceptances and foreign accounts receivable the auditors point out in their certification 'trade acceptances as well as customers' accounts totaling $350,000 are due from companies undergoing receivership.' Also, just how good are the customers' notes under the heading of 'Foreign' and 'Unsecured' which does not appear on the statement is really problematical, unless the sources are known from which these receivables are due."

The committee not having complete information on the question of "customers' notes" refused to make a commitment to this company.

In some instances a principal company will sell to subsidiaries at an excellent profit, and by so doing convert merchandise at one figure into receivables at a larger figure, and thus in a sense pad its statement. In such cases statements showing merchandise carried by subsidiaries should be obtained, and if these companies carry unusually large inventories of wares bought from the parent company, careful scrutiny and caution are necessary.

The statement of the car manufacturing company has some good features, as the almost 100% increase in its quick assets in one year. Yet there are many defects in it which require explanation. It presents a number of angles for discussion and analysis, but space will not permit further comment.

CORPORATION CAR MANUFACTURING COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	12/31/22	12/31/23	6/30/24	12/31/25	12/31/26
Quick Assets	9,451,663	9,849,742	11,085,185	8,747,942	16,009,117
Current Liabilities	4,338,243	4,399,755	4,757,928	1,481,622	7,092,735
Ratio Q. A. to Liabilities	2.18 to 1	2.24 to 1	2.33 to 1	5.91 to 1	2.25 to 1
Surplus Quick Assets	5,113,420	5,449,987	6,327,257	7,266,320	8,916,382
Other Assets	9,042,801	13,442,893	22,614,466	21,312,984	20,861,762
Total Assets Less Current Liabilities	14,156,221	28,892,880	28,941,723	28,579,304	29,778,144
Less Mortgages and Reserves	5,646,000	8,822,929	12,845,000	13,156,602	10,271,212
Net Worth	8,510,221	10,069,951	16,096,723	15,422,702	19,506,932
Capital—Preferred, 1st	3,445,000	3,813,000			
2nd	1,000,000	1,000,000	4,949,300	4,871,700	8,843,900
Capital—Common	250,000	250,000	11,147,423	10,551,002	1,267,000
Surplus	3,815,000	5,006,951			9,396,032
Total Sales		None	available		
Net Operating Profit					2,284,611
Dividends Paid					
Chg'd off, depreciation and bad debts					
Carried to Surplus					
QUICK ASSETS:					
Cash on hand and in bank	1,357,764	950,518	3,114,386	1,313,788	1,528,783
Notes Receivable	3,255,267	3,060,373	3,544,900	4,209,566	6,309,086
Trade or Bank Acceptances				18,016	12,000
Accounts Receivable	1,864,366	2,204,796	1,581,041	1,470,347	1,913,832
Mdse. finished	2,544,266	3,007,056	2,844,858	1,736,224	5,615,400
Mdse. unfinished					
Raw Material					
Listed Stocks and Bonds, U. S.	430,000	627,000	Sinking	Fund cash	60,405
Installment Accounts					43,643
Accrued Interest on Notes					525,968
OTHER ASSETS:					16,009,117
Real Est. Plant, etc	511,758	1,179,918	21,255,692	5,372,633	5,466,210
Machinery and Tools					
Goodwill, Patents, Patterns, etc.	1	1	1	1	1
Due from Officers, etc					
Unlisted Stocks and Bonds	134,277	464,950	389,924	168,218	159,953
Deferred Charges	21,299	42,244	713,216	618,034	
Rolling Stock	8,367,587	11,716,325		15,154,098	14,325,032
Other Assets	7,880	39,455	255,632		910,566
CURRENT LIABILITIES:					20,861,762
Notes Payable	2,550,000	1,274,000	2,300,000		2,800,000
Trade or Bank Acceptances					1,540,000
Accounts Payable	1,788,243	2,966,534	616,383	720,284	1,474,276
Individual's Deposits					94,715
Div. Payable		159,221	466,968	466,968	534,842
Taxes, Interest, etc			1,374,577	294,370	648,902
OTHER LIABILITIES:					
Mortgages	5,571,000	7,844,000	12,845,000	11,855,000	9,252,000
Deferred Profits				807,790	807,790
Reserve Accounts, Amortization		732,284		493,812	211,422
Reserve Accounts, Profit on Cars (Instal.)	75,000	246,645			

Outstanding with Commercial Paper Brokers—12/1/1926 800,000

Phonograph, Radio, Etc., Manufacturing Company.—This company was regarded as being interested in too many lines of business. In addition, it was known that the concern had made a radical change in some of the principal lines of its business, and the discount committee expressed a desire to defer the purchase of the paper for one year in order to determine the judiciousness of such purchase. In addition, a careful analysis of the company's various products showed that it was rapidly converting its phonograph business into that of radio sets and accessories. However, the radio line at the date of the last statement was not stabilized. Marked changes in design and production were made, and the committee felt that the purchase of this note should not be made until such time as the company had demonstrated its ability to meet the changing conditions in the industry.

CORPORATION — PHONOGRAPH, RADIO, ETC., MANUFACTURING COMPANY

Comparison of Statements

CONDENSED STATEMENT:

Date	12/31/21	12/31/22	6/30/23	3/31/24	12/31/25	12/31/26
Quick Assets	14,787,655	20,668,141	25,531,486	21,335,979	23,169,612	25,124,447
Current Liabilities	4,676,594	6,682,970	11,372,729	8,721,056	8,808,219	10,217,465
Ratio Q. A. to Liabilities	3.16 to 1	3.09 to 1	2.24 to 1	2.45 to 1	2.6 to 1	2.43 to 1
Surplus Quick Assets	10,111,061	13,985,171	14,158,757	12,614,923	14,361,393	14,906,982
Other Assets	6,479,398	8,463,889	16,429,386	15,551,098	12,982,553	13,445,092
Total Assets Less Current Liabilities	16,590,459	22,449,060	30,588,143	28,166,021	27,343,946	28,352,074
Less Mortgages and Reserves		3,600,000	3,200,000	2,800,000	2,694,998	2,399,998
Net Worth	16,590,459	18,849,060	27,388,143	25,366,021	24,648,948	25,952,076
Capital—Preferred	4,833,500	4,833,500	4,818,500		4,750,000	4,737,500
			9,000,000			
Capital—Common (A)	6,000,000	6,000,000	13,500,000	17,193,500	12,375,000	12,375,000
Capital—Common (B)						
Surplus	5,756,959	8,015,560	69,643	8,172,521	7,523,948	8,839,576
Total Sales					25,000,000	28,500,000
Net Profit or Loss	1,162,562	5,046,099				2,835,949
Dividends Paid	428,366	758,314				1,200,000
Chg'd off, depreciation and bad debts						
Taxes, etc		2,029,185				
Carried to Surplus	734,196	2,258,601				

(Continued on opposite page)

QUICK ASSETS:						
Cash on hand and in bank	607,563	963,303	978,667	1,086,298	1,291,793	1,896,085
Notes Receivable	2,422,681	2,704,506	4,038,649	4,662,157	4,859,193	5,122,650
From Officials		346,000				
Accounts Receivable	2,733,454	4,077,095	4,349,554	4,150,421	6,064,922	6,137,683
Mdse. finished	8,551,016	12,098,415	16,166,616	11,437,102	10,702,773	11,764,728
Mdse. unfinished						
Raw Material						
Listed Stocks and Bonds, U. S. and Can. Gov. Bonds	472,941	478,823				
			Due on	stkh'drs' sub.	250,839	203,300
	14,787,655	20,668,141				
OTHER ASSETS:						
Real Est. Plant, etc	6,043,267	7,674,830	15,398,103	14,708,440	11,510,916	11,845,884
Machinery and Tools						
Goodwill, Patents, Patterns, etc						
Due from Officers, etc						
Unlisted Stocks and Bonds	165,158	220,876	205,513	164,384	196,937	334,769
Deferred Charges	270,973	568,183	825,769	678,273	759,324	691,009
Slate, Quarry and Timber Lands						
			Notes	Receivable	685,714	571,428
	6,479,398	8,463,889				
CURRENT LIABILITIES:						
Notes Payable		400,000	9,586,400	7,167,740	6,324,000	7,608,000
Bills Payable	3,454,000	2,069,199	6% Gold	Notes Due	484,000	400,009
Accounts Payable	878,002	2,949,184	1,528,390	1,237,270	1,795,123	1,578,110
Federal Taxes	200,000	1,000,000	131,819	10,533		322,000
Reserve	60,000	60,000	126,119	179,189		154,438
Acc. Int. and Div.	84,592	204,586		126,324	205,096	154,906
OTHER LIABILITIES:	4,676,594	6,682,970				
Mortgages		3,600,000	3,200,000	2,800,000	2,694,998	2,399,998
Reserve Accounts						

Outstanding with Commercial Paper Brokers

Dec. 1, 1923	5,485,000
Aug. 11, 1922	5,100,000

Manufacturing Company of Porosknit Underwear.—The statement of this company indicates on its face an acceptable condition, the ratio being 2.93 to 1. It is further apparent that a liberal inventory is carried, and a careful scrutiny of this item elicited the information that a large portion of this represented goods in process of manufacture. It so happened that at the time the paper was considered by the committee, sales in this line fell off materially, and cancellations were quite common. The committee accordingly felt that the inventory in process could be completed only at a considerable loss and it decided to await the effect these conditions would have on the company's condition.

Business prospects were also not considered very good at the time of the paper offering.

CORPORATION MANUFACTURING COMPANY OF POROSKNIT UNDERWEAR

Comparison of Statements .....

CONDENSED STATEMENT:

Date	12/31/24	12/31/25	8/1/26
Quick Assets	2,431,213	2,622,660	2,303,273
Current Liabilities	1,103,180	776,229	785,891
Ratio Q. A. to Liabilities	2.20 to 1	3.38 to 1	2.93 to 1
Surplus Quick Assets	1,328,033	1,846,431	1,517,382
Other Assets	886,888	874,397	959,292
Total Assets Less Current Liabilities	2,214,921	2,720,828	2,476,674
Less Mortgages and Reserves		775,000	775,000
Net Worth	2,214,921	1,945,838	1,701,674
Capital—Preferred 1st	390,000		
Capital—Preferred 2nd	250,000	640,000	640,000
Capital—Common	400,000	400,000	400,000
Surplus	1,174,921	905,838	661,674
	2,214,921	1,945,838	1,701,674
Total Sales	2,727,978	2,723,774	1,023,202 (7 Months only)
Net Profit or Loss			
Dividends Paid			
Chg'd off, depreciation and bad debts	19,500	37,944	
Carried to Surplus			
QUICK ASSETS:			
Cash on hand and in bank	271,626	580,024	277,890
Notes Receivable	99,871	78,858	87,757
Trade or Bank Acceptances			
Accounts Receivable	451,796	323,918	320,055
Mdse. finished	1,596,507		
Mdse. unfinished	584,492	1,638,250	2,303,273
Raw Material			
Listed Stocks and Bonds	937	838	838
Misc. Accts. Receivable	10,476	781	4,035
OTHER ASSETS:			
Real Est. Plant, etc.	861,991	776,281	817,326
Machinery and Tools			
Goodwill, Patents, Patterns, etc.			
Due from Officers, etc.			
Unlisted Stocks and Bonds			
Deferred Charges	24,897	98,116	75,718
Sinking Fund			66,248
CURRENT LIABILITIES:			
Notes Payable	801,001	740,000	700,000
Trade or Bank Acceptances			
Accounts Payable	161,743	22,187	64,252
Individual's Deposits			
Acc. Wages, etc.	13,880	14,041	21,639
Res. for Federal Taxes	126,556		
OTHER LIABILITIES:			
Mortgages 5 years		775,000	775,000
Reserve Accounts			
	Outstanding with Commercial Paper Brokers. 4/1/26 732,500		

Wholesale Grocery Company.—In spite of some strong points in the statement apparent upon close analysis the note of the company was rejected. A careful analysis of the company's business and the composition of its inventories disclosed the fact that 75% of the volume and a like amount of the inventory were made up of canned goods. It may be recalled that a considerable amount of canned food products were dumped upon the market in those years by the government, and by large canneries because of the cancellation of contracts, and as a consequence it was felt that the market would remain demoralized for no brief period of time.

CORPORATION WHOLESALE GROCERY COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	12/31/19	12/31/20	12/31/21
Quick Assets	608,289	646,958	768,973
Current Liabilities	222,899	197,202	334,623
Ratio Q. A. to Liabilities	2.72 to 1	3.29 to 1	2.30 to 1
Surplus Quick Assets	385,390	449,756	434,350
Other Assets	98,216	98,609	110,809
Total Assets Less Current Liabilities	483,606	548,365	545,159
Less Mortgages and Reserves	28,247	32,906	37,589
Net Worth	455,359	515,359	507,570
Capital—Preferred			
Capital—Common	250,000	250,000	250,000
Surplus	205,359	265,360	257,570
	455,359	515,360	507,570
Total Sales	1,588,212	1,900,000	
Net Profit or Loss	42,151	91,756	
Dividends Paid	25,000	25,000	
Chg'd off, depreciation and bad debts			
Carried to Surplus			
QUICK ASSETS:			
Cash on hand and in bank	3,490	5,401	44,334
Notes Receivable	38,796	24,313	52,911
Trade or Bank Acceptances			
Accounts Receivable	239,110	181,394	452,137
Mdse. finished	321,042	434,167	219,591
Mdse. unfinished			
Raw Material			
Listed Stocks and Bonds, U. S.	4,815	130	
Interest Payable	84	554	
Stamps and War Savings	952	1,000	
OTHER ASSETS:			
	352	267	
Real Est. Plant, etc.	79,623	78,423	78,844
Machinery and Tools	10,810	11,288	28,113
Goodwill, Patents, Patterns, etc.	7,431	8,531	
Due from Officers, etc.			
Unlisted Stocks and Bonds			846
Deferred Charges			3,007
CURRENT LIABILITIES:			
Notes Payable	220,260	170,000	300,000
Trade or Bank Acceptances			
Accounts Payable	2,639	27,202	12,923
Individual's Deposits			21,700
OTHER LIABILITIES:			
Mortgages			
Reserve Accounts	28,247	32,906	37,589

Provision Company.—In this case the company has too small cash balances, although its statement in other respects appears acceptable. There is no set proportion of cash to be looked for, this depending entirely upon the rapidity with which receivables are turned into cash and the amount and maturity of the debts.

CORPORATION PROVISION COMPANY

Comparison of Statements

CONDENSED STATEMENT:

Date	11/2/23	2/28/24	10/30/25	10/29/26
Quick Assets	7,237,695	12,937,683	11,254,483	9,779,194
Current Liabilities	4,341,942	9,529,782	6,879,522	4,919,403
Ratio Q. A. to Liabilities	1.67 to 1	1.36 to 1	1.63 to 1	1.99 to 1
Surplus, Quick Assets	2,895,753	3,407,901	4,374,961	4,859,791
Other Assets	1,533,018	1,399,453	1,360,080	1,308,571
Total Assets Less Current Liabilities	4,428,771	4,807,354	5,735,041	6,168,362
Less Mortgages and Reserves	49,390	13,747		
Net Worth	4,379,381	4,793,607	5,735,041	6,168,362
Capital—Preferred				
Capital—Common	2,000,000	2,000,000	2,000,000	2,000,000
Surplus	2,379,381	2,793,607	3,735,041	4,168,362
	4,379,381	4,793,607	5,735,041	6,168,362
Total Sales		None available		
Net Profit or Loss				
Dividends Paid				
Chg'd off, depreciation and bad debts				
Carried to Surplus				
QUICK ASSETS:				
Cash on hand and in bank	7,383	7,180	20,181	13,943
Notes Receivable				
Trade or Bank Acceptances				
Accounts Receivable	7,032,518	8,280,885	11,189,679	9,603,987
Mdse. finished	197,794	4,649,618	44,623	161,263
Mdse. unfinished				
Raw Material				
Listed Stocks and Bonds				
OTHER ASSETS:				
Real Est. Plant, etc.	1,502,978	1,260,208	1,220,788	1,224,046
Machinery and Tools		61,795	61,752	31,965
Goodwill, Patents, Patterns, etc.				
Due from Officers, etc.				
Unlisted Stocks and Bonds	30,040	77,450	77,540	52,560
Deferred Charges				
CURRENT LIABILITIES:				
Notes Payable	4,314,400	9,478,500	6,764,200	4,869,400
Trade or Bank Acceptances				
Accounts Payable				
Individual's Deposits	27,542	51,282	115,322	50,003
OTHER LIABILITIES:				
Mortgages				
Reserve Accounts				
Taxes and Ins.	49,390	13,747		
	Outstanding with Commercial Paper Houses.			
	8/31/25	2/1/26	8/11/26	
	1,884,800	1,584,000	1,181,000	

Wholesale and Retail Hardware Company.—This company had only one bank account which was not thought enough considering its size. It is generally thought by representative commercial paper buying banks that a concern should have sufficient open bank lines for promptly taking up open market obligations outstanding, in the event that sale of paper in the market is discontinued.

It will be recalled that prior to the establishment of the Federal Reserve Banks there were extreme periods of tight and easy money, and the old-time banker wanted to be certain that there were sufficient amounts of unused bank credit available at the depositary institutions to take care of the maturities in the open market. Today, with the establishment of the Federal Reserve System and the discount privileges enjoyed by member banks, this requirement has become of less importance, although it is still a desirable consideration in the purchase of open market notes.

CORPORATION WHOLESALE AND RETAIL HARDWARE CO.

Comparison of Statements .....

CONDENSED STATEMENT:

Date	2/1/23	2/1/24	2/1/25	2/1/26
Quick Assets	903,199	629,117	621,210	687,646
Current Liabilities	199,726	168,020	96,806	145,791
Ratio Q. A. to Liabilities	4.52 to 1	3.68 to 1	6.41 to 1	4.71 to 1
Surplus Quick Assets	703,473	461,097	524,404	541,855
Other Assets	135,683	140,066	190,643	220,144
Total Assets Less Current Liabilities	839,156	601,163	715,047	761,999
Less Mortgages and Reserves	19,716	26,039	97,953	115,900
Net Worth	819,440	575,124	617,094	646,099
Capital—Preferred	200,000	200,000		
Capital—Common	300,000	300,000	300,000	300,000
Surplus	319,440	75,124	317,094	346,099
	819,440	575,124	617,094	646,099
Total Sales			1,200,000	1,500,000
Net Profit or Loss			72,000	100,000
Dividends Paid			60,000	60,000
Chg'd off, depreciation and bad debts				
Carried to Surplus				
QUICK ASSETS:				
Cash on hand and in bank	2,870	19,736	18,028	5,670
Notes Receivable	151,069	107,734	82,417	86,605
Trade or Bank Acceptances				
Accounts Receivable	164,702	130,584	159,526	176,518
Mdse. finished				
Mdse. unfinished	541,106	338,602	361,237	421,852
Raw Material				
Listed Stocks and Bonds, U. S.	43,450	32,460		
OTHER ASSETS:				
Real Est. Plant, etc	124,899	110,862	165,258	186,406
Machinery and Tools		13,543	1,177	6,450
Goodwill, Patents, Patterns, etc				
Due from Officers, etc				
Unlisted Stocks and Bonds				
Deferred Charges				
Furniture and Fixtures			7,746	7,362
Autos and Trucks			11,709	15,162
Unexpired Insurance	10,784	15,660	4,751	4,762
CURRENT LIABILITIES:				
Notes Payable	101,014	109,333	70,000	130,000
Trade or Bank Acceptances				
Accounts Payable	98,711	21,307	26,806	15,791
Individual's Deposits				
Deferred Liabilities		37,378	97,953	
OTHER LIABILITIES:				
Mortgages, Con. Coal and Warehouse Notes (Secured)				115,900
Reserve Accounts	19,716	26,039		

Dairy Machinery Manufacturing Company.—An analysis of this statement shows the following:

1. A decreasing current ratio
2. Quick assets less than three years previous
3. Cash balances less by about 75% than a year previous
4. Notes payable greater each year
5. Net worth less than in 1924
6. Continual decrease in sales and increased competition Concern shows lack of progress.

CORPORATION — DAIRY MACHINERY MANUFACTURING CO.

Comparison of Statements .....

CONDENSED STATEMENT:

Date	8/31/24	8/31/25	8/28/26
Quick Assets	2,146,736	1,598,911	1,769,195
Current Liabilities	684,877	463,510	637,798
Ratio Q. A. to Liabilities	3.13 to 1	3.45 to 1	2.77 to 1
Surplus Quick Assets	1,461,859	1,135,401	1,131,397
Other Assets	3,619,394	3,611,192	3,630,445
Total Assets Less Current Liabilities	5,081,253	4,746,593	4,761,842
Less Mortgages and Reserves	540,000	480,000	490,470
Net Worth	4,541,253	4,266,593	4,271,372
Capital—Preferred	2,230,973	2,221,123	2,221,123
Capital—Common	2,000,000	2,000,000	2,000,000
Surplus	3,102,800	45,470	50,249
	4,541,253	4,266,593	4,271,372
Total Sales	3,897,395	3,092,409	2,903,525
Net Profit or Loss			
Dividends Paid			
Chg'd off, depreciation and bad debts			
Carried to Surplus			
QUICK ASSETS:			
Cash on hand and in bank	82,081	98,204	25,552
Notes Receivable			165,721
Accounts Receivable	920,844	641,552	562,770
Mdse. finished	1,143,811	859,154	994,519
Mdse. unfinished			
Raw Material			
Listed Stocks and Bonds			20,634
OTHER ASSETS:			
Real Est. Plant, etc	539,353	1,081,355	1,058,038
Machinery and Tools	447,655		
Goodwill, Patents, Patterns, etc	2,517,612	2,402,861	2,404,140
Due from Officers, etc			
Unlisted Stocks and Bonds	17,748	20,839	
Deferred Charges	97,028	106,137	168,267
CURRENT LIABILITIES:			
Notes Payable	273,300	371,400	562,300
Trade or Bank Acceptances			
Accounts Payable	155,153	63,409	32,076
Individual's Deposits			
Accruals, Div., Taxes, etc	156,424	28,701	43,422
OTHER LIABILITIES:			
Mortgages, 60,000 Annually	540,000	480,000	480,000
Reserve Accounts			10,470

Milling Company.—The statement submitted was not recent enough, and the outstanding commercial paper was found so far in excess of the bank lines that the committee felt that it was inadvisable to extend accommodations.

Attention is called to the unusually heavy ratio of current assets to current liabilities, which is far above normal. The company practically owes nothing. This, however, is only natural with a milling company on June 30, when it is virtually liquidated. It has been found that one bad season alone will sometimes cause embarrassment to a concern in this line.

Attention is further called to the fact that while no notes payable were outstanding on the statement date, 3 months later the company owed $285,000 through the brokers. This more properly brings out the seasonal condition in this line, and the importance of having a sufficient amount of unsecured bank lines at the peak of the season to take care of open market notes in the event that circumstances prevent their further sale.

CORPORATION — MILLING COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	6/30/24	6/30/25	6/30/26
Quick Assets	601,103	670,619	438,518
Current Liabilities	18,538	15,546	11,044
Ratio Q. A. to Liabilities	32.42 to 1	43.13 to 1	39.70 to 1
Surplus Quick Assets	582,565	655,073	427,474
Other Assets	125,717	87,413	341,333
Total Assets Less Current Liabilities	708,282	742,486	768,809
Less Mortgages and Reserves			
Net Worth	708,282	742,486	
Capital—Preferred			
Capital—Common	200,000	200,000	200,000
Surplus	508,282	542,486	568,809
	708,282	742,486	768,809
Total Sales		1,953,022	1,466,259
Net Profit or Loss			
Dividends Paid			
Chg'd off, depreciation and bad debts			
Carried to Surplus			
QUICK ASSETS:			
Cash on hand and in bank	187,598	222,015	58,157
Notes Receivable	14,594	18,328	30,595
Trade or Bank Acceptances			
Accounts Receivable	256,818	257,025	180,556
Misc. finished	140,044	173,221	152,375
Misc. unfinished			
Raw Material			
Listed Stocks and Bonds	2,049		14,835
OTHER ASSETS:			
Real Est. Plant, etc.	115,189	76,887	192,575
Machinery and Tools			
Goodwill, Patents, Patterns, etc.			
Due from Officers, etc.			
Unlisted Stocks and Bonds	10,526	10,526	139,600
Deferred Charges			
Miscellaneous			9,158
CURRENT LIABILITIES:			
Notes Payable			
Trade or Bank Acceptances			
Accounts Payable	12,464	8,869	7,487
Individual's Deposits	6,074	6,677	3,557
OTHER LIABILITIES:			
Mortgages			
Reserve Accounts			

Bank Lines Available	240,000
Outstanding through Broker Sept. 1, 1927	285,000

Office Machine Manufacturing Company.—The affairs of this concern were found to be so interwoven with the affairs of other companies that its status was not readily determined. It was felt that in the event of its embarrassment, it would be disclosed that large receivables were due from affiliated companies, and that these affiliations carried liberal inventories to enable the borrowing company to show larger amounts of receivables, that is, a padded statement.

CORPORATION OFFICE MACHINE MANUFACTURING COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	12/31/25	7/31/26
Quick Assets	2,575,965	2,633,206
Current Liabilities	1,223,297	1,085,444
Ratio Q. A. to Liabilities	2.11 to 1	2.42 to 1
Surplus Quick Assets	1,352,668	1,547,762
Other Assets	3,563,195	3,445,106
Total Assets Less Current Liabilities	4,915,863	4,992,868
Less Mortgages and Reserves	295,687	375,718
Net Worth	4,620,176	4,617,150
Capital—Preferred	1,000,000	1,000,000
Capital—Common	1,075,000	1,075,000
Surplus	2,545,176	2,542,150
	4,620,176	4,617,150
Total Sales	None	available
Net Profit or Loss		
Dividends Paid		
Chg'd off, depreciation and bad debts		
Carried to Surplus		
QUICK ASSETS:		
Cash on hand and in bank	94,354	61,298
Notes Receivable	4,617	19,169
Trade or Bank Acceptances		
Accounts Receivable	996,806	998,172
Mdse. finished	1,400,187	1,441,570
Mdse. unfinished		
Raw Material		
Listed Stocks and Bonds		
OTHER ASSETS:		
Real Est. Plant, etc	1,531,222	1,775,032
Machinery and Tools		
Goodwill, Patents, Patterns, etc	1,667,787	1,666,190
Due from Officers, etc		
Unlisted Stocks and Bonds	3,500	3,884
Deferred Charges	23,528	112,996
Due from Affiliated Companies	85,006	
Com. Advances	252,151	
CURRENT LIABILITIES:		
Notes Payable	1,026,500	940,000
Trade or Bank Acceptances		
Accounts Payable	165,087	128,754
Individual's Deposits		
Accruals	31,710	16,690
OTHER LIABILITIES:		
Mortgages		
Reserve Accounts		

Jewelry Company.—At the time, the rate of interest which the subject company was willing to pay the bank was deemed too low to be advantageous. This company shows a fair position, but the committee decided to forego its offering, primarily because the inventory was exceedingly slow-moving, and the committee felt that the rate of interest should have been slightly more attractive.

CORPORATION JEWELRY COMPANY

Comparison of Statements .....

CONDENSED STATEMENT:

Date	3/1/24	3/1/25	2/28/26
Quick Assets	1,899,972	1,675,163	1,642,066
Current Liabilities	871,218	760,713	623,698
Ratio Q. A. to Liabilities	2.18 to 1	2.20 to 1	2.63 to 1
Surplus Quick Assets	1,028,754	914,450	1,018,368
Other Assets	328,956	564,570	559,569
Total Assets Less Current Liabilities	1,357,710	1,479,020	1,577,937
Less Mortgages and Reserves			160,000
Net Worth	1,357,710	1,479,020	1,417,937
Capital—Preferred	637,800	631,800	630,600
Capital—Common	300,000	300,000	300,000
Surplus	419,910	387,220	487,337
	1,357,710	1,479,020	1,417,937
Total Sales			1,750,000
Net Profit or Loss			
Dividends Paid			
Chg'd off, depreciation and bad debts			
Carried to Surplus			
QUICK ASSETS:			
Cash on hand and in bank	56,711	62,193	38,450
Notes Receivable			2,016
Trade or Bank Acceptances			
Accounts Receivable	424,490	431,380	457,155
Mdse. finished	1,218,772	1,181,590	1,105,455
Mdse. unfinished			23,988
Stationery Department			
Listed Stocks and Bonds			15,000
Second Mtg. Rec			
OTHER ASSETS:			
Real Est. Plant, etc	328,956	564,570	414,232
Machinery and Tools			45,337
Goodwill, Patents, Patterns, etc			
Due from Officers, etc			
Unlisted Stocks and Bonds			
Deferred Charges			
CURRENT LIABILITIES:			
Notes Payable	766,000	700,000	576,000
Trade or Bank Acceptances			
Accounts Payable		30,475	18,050
Individual's Deposits	125,218	30,238	
Loans Payable			29,648
OTHER LIABILITIES:			
Mortgages		160,000	160,000
Reserve Accounts			

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